

# The First Budget of a Free Iran: Building a Foundation of Prosperity

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## INTRODUCTION

In this chapter, we present the general contours of budgetary challenges that the transitional government faces in the immediate aftermath of the Islamic Republic's collapse, through the period when the first elected government assumes power, and the long-term budgetary issues that must be addressed thereafter. In the short- and medium-terms, the priority is to maintain continuity of the administrative state's functions and services for the duration of the transition period, and to lay the foundations for structural reforms to be carried out once the elected government has acquired a constitutional mandate. Based on available data, we offer solutions that may require significant alterations, due to the fluid, fast-changing, and uncertain nature of post-Islamic Republic realities. In the long-run, we envision weaning the government's budget from hydrocarbon revenues, transforming it to be fully tax-funded, and subject to parliamentary oversight. We expect the post-Islamic Republic government's economic policy stance to be pro-market and pro-growth. To this end, we recommend reforms that streamline the budget process and focus on providing core governmental services efficiently. In addition, we recommend a complete overhaul of the taxation system, both corporate and income taxes in order to raise optimal funding for government's operations, increase economic efficiency, and share the tax burden optimally. We recommend reorienting government agencies from central planning—defined as an active and direct role in channeling investments, intervention in the production process, and frequent meddling in markets for goods and services—to provide security, stability, and services necessary to empower citizens, the domestic private sector, and international investors.

As discussed earlier in the document, we envision three distinct phases during the transition, with their distinct features, requirements, and challenges. In the first 100 to 180 days after the transitional government takes over, it must assert control over fiscal and financial policy-making institutions, secure the payment system, and ensure the continuity of governmental services. As with the other chapters of this series, we maintain that the transition of power is orderly and the transitional government asserts (a reasonable level of) sovereignty over the country; it provides a high-level of security in the capital, major urban areas, administrative centers, and reasonable levels in other areas in the transition period. It is crucial that the United States, the European Union, the People's Republic of China, the United Nations, and major neighboring countries recognize the transitional government as the legal and sovereign successor to the Islamic Republic. Thus, upon recognition the transitional government can establish channels of communication with the United States, the European Union, China, the International Monetary Fund, and the United Nations to receive aid (if necessary) and access Iran's blocked financial assets.

A paramount goal is to prevent the collapse of private consumption which accounts for roughly half of the country's output, and more pressingly, to avoid widespread bank runs that may cripple the financial system (refer to the banking chapter in this document). Following this phase, the transitional government must oversee several national referenda to determine the future political system, draft the new constitution, and hold parliamentary and executive general elections. During this period, which may take between one to two years, the transitional government must spearhead reforms that do not require a constitutional mandate. Following the conclusion of the constitutional convention and with a conventional liberal-democratic and market-oriented government in power, the task of implementing fundamental fiscal and budgetary reforms begins in earnest. Among them, we note an overhaul of the social welfare system (i.e., social security, public health, transfer payments, etc.) and education expenditure, are both in deep crisis. In addition, the transfer of ownership of many state-owned and quasi state-owned enterprises to the private sector and reorienting of the budget funding from hydrocarbon revenues to a sustainable tax-and-public borrowing-based system must happen at this stage.

Thanks to decades-long sanctions and almost complete isolation from the global markets, Iran has negligible foreign debt and other sovereign obligations. While chronic double-digit inflation, double-digit unemployment, and anemic output growth pose significant challenges to the Islamic Republic's successor state, the Iranian economy runs a large trade surplus and has significant frozen assets abroad. Moreover, Iran has not tapped into resources available to members of the IMF and other international institutions in over half a century. Thus, with gestures of goodwill from the United States and the European Union governments, such as executive orders to temporarily relieve or suspend sanctions and unfreeze Iran's frozen assets, alongside small token sovereign loans, funding the government budgets in the transitional period is feasible.<sup>1</sup> Furthermore, easing or outright removal of sanctions coupled with the country's return to the international trade system would immediately revive growth and replenish the government's tax revenues. In the absence of sovereign obligations, the major task facing the government is to lay the foundations of prudent and sustainable budgetary practices and effective macroeconomic stewardship.

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<sup>1</sup> Such actions could resemble limited sanctions relief granted to Syria following the fall of Bashar Al-Asad's regime. See [here](#) for an example.

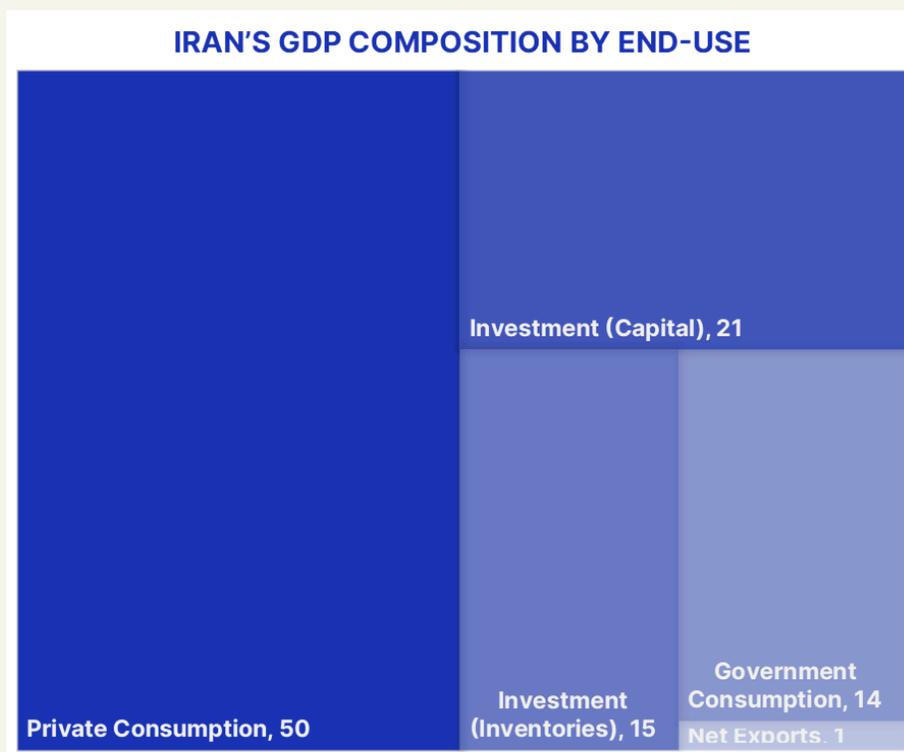


FIGURE 1: GDP Compositions.

## AN OVERVIEW OF IRAN'S GOVERNMENT BUDGET UNDER THE ISLAMIC REPUBLIC

In order to better examine the budgetary landscape, it is important to first note that government expenditures, the principal budgetary item, are roughly 25% of Iran's \$401.5B GDP, that includes government consumption and a significant portion of investments (both capital and inventories), as seen in Figure 1.<sup>2</sup> For example, the proposed 2025-2026 budget—based on the exchange rate used—ranges between \$88B and \$127B USD.<sup>3</sup>

As previously mentioned, a salient feature of Iran's fiscal profile is minimal domestic and international sovereign debt. Iran's domestic government debt markets are small, underdeveloped, and peripheral to funding budget deficits (see the financial markets chapter in this handbook). As an example, the government could only raise between \$276MM and \$392MM through issuing "Shari'a compliant" bonds between March and September 2024.<sup>4</sup> Since the country has been under sanctions and effectively cut off from the global financial markets for decades, it has negligible foreign currency-denominated sovereign debt. This is a notable advantage for the transitional government, since it does not need to negotiate debt restructuring or payment plans with foreign creditors. On the other hand, the current treasury personnel lack the required knowledge and capacity to tap global financial markets to fund potential shortfalls. Based on the relevant case studies of other countries, capacity building and knowledge transfer could be expedited following the transition.<sup>5</sup>

<sup>2</sup> Iran country profile, International Monetary Fund, accessed June 2024 and World Bank Global Economic Prospects, June 2024.

<sup>3</sup> Refer to the 1404 Budget Proposal to the Majlis (1404, equivalent to 2025-2026) [link](#).

<sup>4</sup> Refer to data published by the Central Bank of Iran ([www.cbi.ir](http://www.cbi.ir)).

<sup>5</sup> A relevant example is Poland's rapid capacity building and reforms under the "Balcerowicz Plan" between 1989-1991.

As a consequence of the aforementioned circumstances, the Islamic Republic's successive governments have extensively borrowed from the banking system (estimates ranging between 10 to 15 percent of GDP annually, on average, and between 80 to 140 percent of GDP cumulatively)<sup>6</sup> and the National Investment Fund (Iran's sovereign wealth fund). The level and the persistence of these borrowings—which have continued unabated since the 1980s—are the primary factor contributing to Iran's chronic double-digit inflation.<sup>7</sup> As an example, the proposed 2025-2026 budget features a whopping 31 percent deficit (as a share of the proposed budget).<sup>8</sup>

The Iranian budget expenditures, consistent with other centralized and aging middle-income countries, is skewed toward entitlement programs (i.e., social security, health care, consumer subsidies, etc.) as seen on Figures 2 and 3. It is immediately evident that over time, the government has directed increasingly larger shares of their budget to entitlement programs, and that this trend has continued with the tightening of international sanctions since the 2010s.

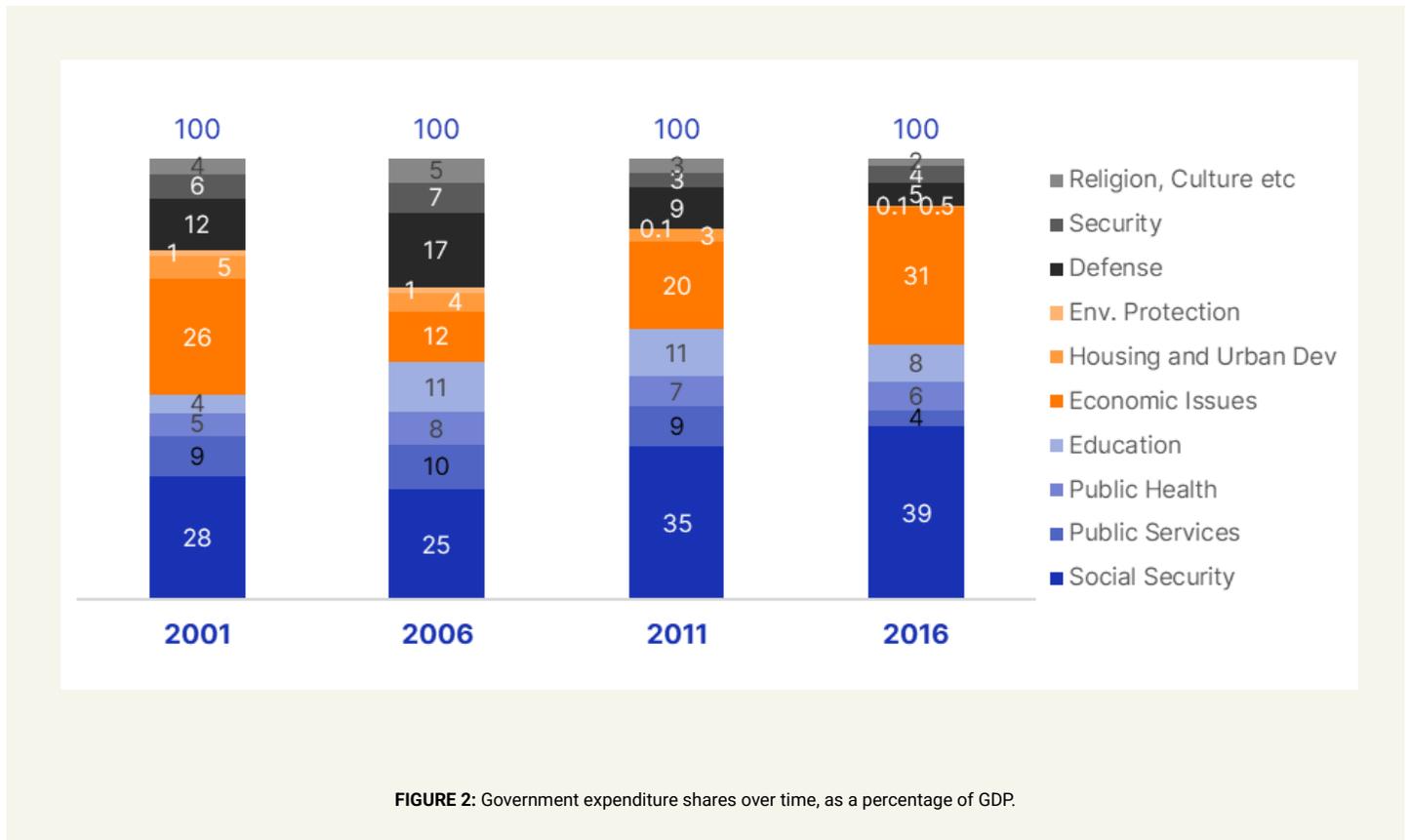


FIGURE 2: Government expenditure shares over time, as a percentage of GDP.

An important issue to study is the decomposition of government revenues and expenses, as reflected in the available budget data. As we discuss later on, one challenge facing the transitional government is potential loss of revenues, which might impose moderate to severe stress on the administrative state's capacity to deliver services.

In Figure 3 below, payroll and transfer payments (entitlements) are the two principal budgetary expense items, followed by subsidies and procurement of goods and services. We already touched on the rising share of entitlement programs in budgetary expenditure. The share of social welfare and transfer payments have exceeded 35 percent of government expenditures every year since 2017. Payroll expenses pertain to the number of civil servants employed by the government; those employed in education, armed and security forces,

<sup>6</sup> These estimates do not reflect borrowing by state-owned or quasi state-owned enterprises.

<sup>7</sup> See, for example: [link](#).

<sup>8</sup> See [link](#).

and civil services comprise the bulk of the recipients. The Iranian civil service and education apparatus is notoriously bloated, inefficient, and sluggish. At the same time, against a backdrop of deteriorating living standards, anemic economic growth, chronically high unemployment and inflation, a weak and severely repressed private sector, and unstable trade relations, government jobs are viewed as stable and desirable. Roughly 2.25 million full-time wage-earners, about 15 percent of the labor force, are on government payroll. If we include over a million members of the armed forces and security services, this number reaches about 3.5 million individuals.

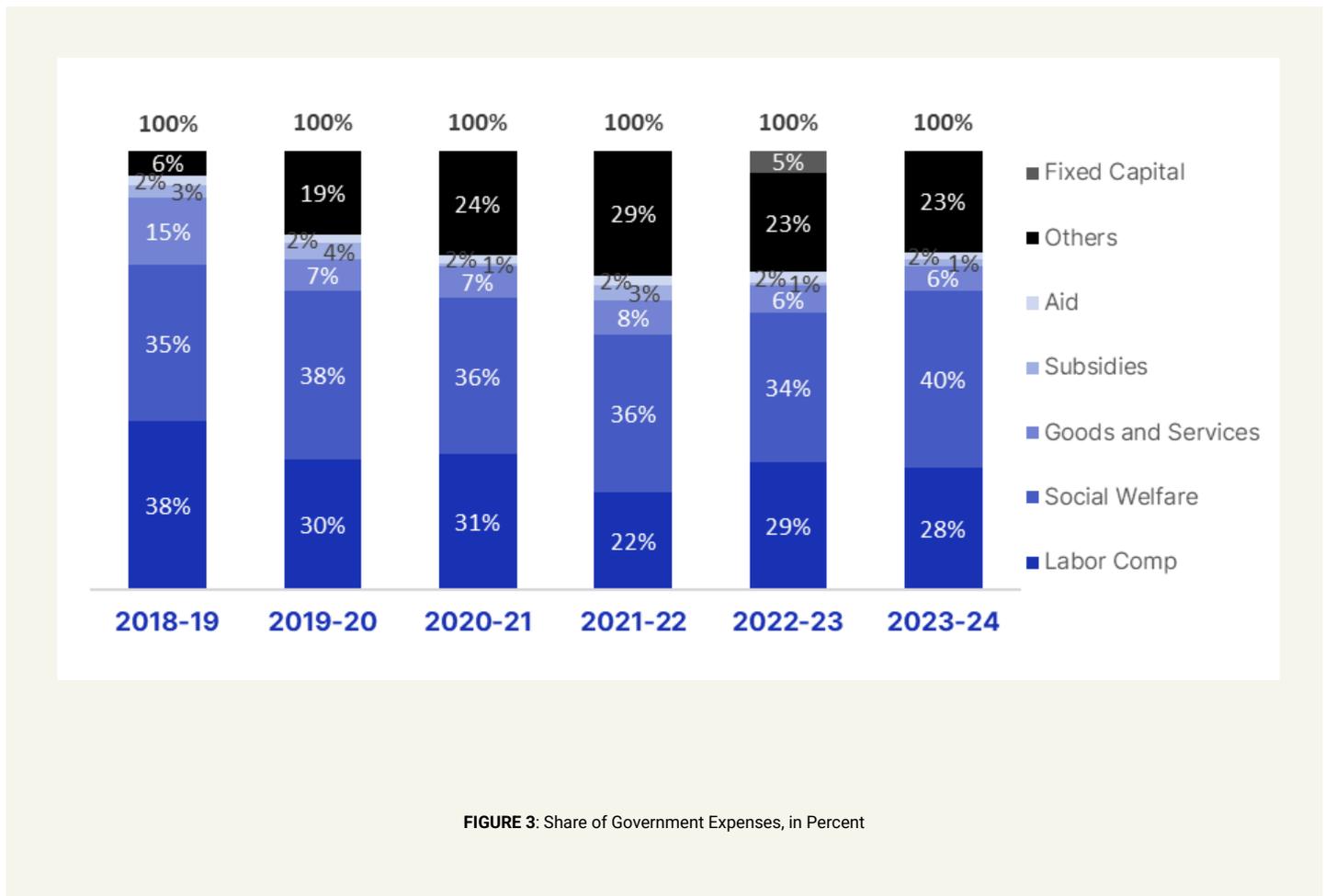


FIGURE 3: Share of Government Expenses, in Percent

As seen in Figure 4, while tax revenues have risen over time, oil and natural gas sales, proceeds from sales of state-owned assets, and revenues from state-owned enterprises remain key sources for funding the government.<sup>9</sup> Alarmingly, successive Islamic Republic governments have treated social safety net tax revenues as operating income. This abusive practice has contributed to the critical condition of the national social security trust fund. A medium-term goal of the successor government to the Islamic Republic must be weaning the budget from non-tax revenues. It should also take concrete steps to remedy the mismanagement of the national social security funds. The public welfare chapter in this handbook discusses these issues extensively.

During the transition period, government revenues could potentially experience strains as the realization of political, security, or economic risks may adversely affect the ability of the government to collect taxes or claim proceeds from other revenue streams.

<sup>9</sup> Deeply unpopular and anti-growth wealth taxes account for a notable portion of these rising tax revenues.

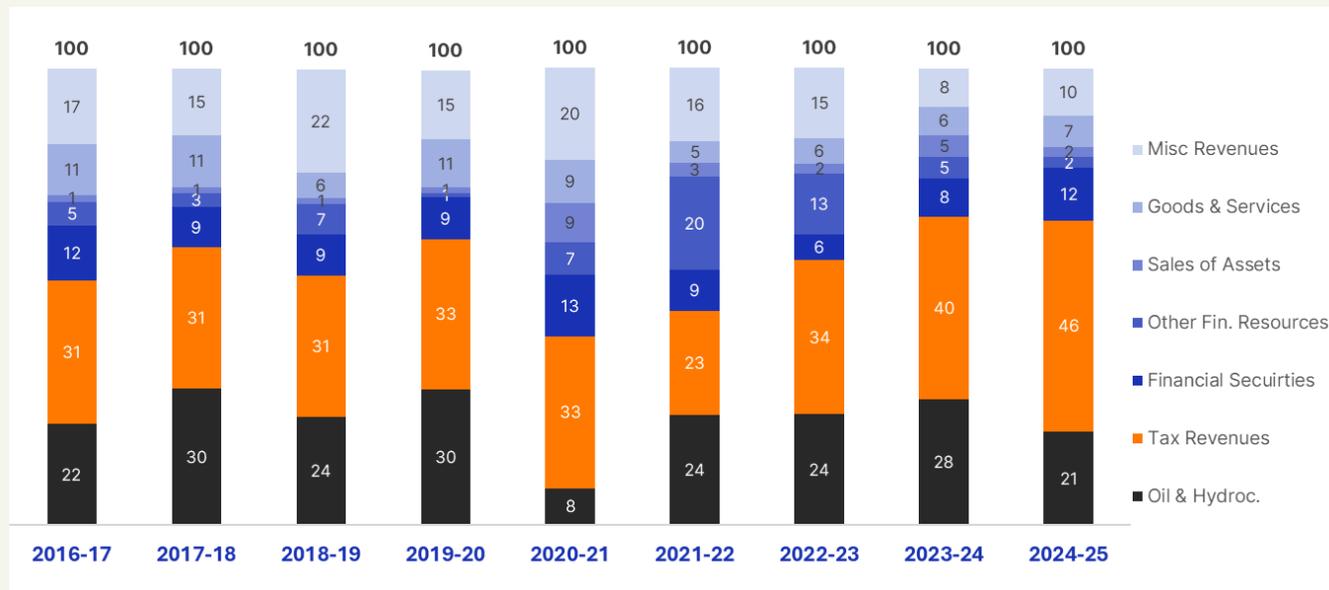


FIGURE 4: Government Revenues, in Percent

We envision three distinct scenarios for a loss of government revenues. The likely scenarios focus on the loss of fiscal capacity (for about one to two years):

- **NOTABLE LOSS OF CAPACITY:** government revenues decline by approximately 20 percent. In this situation, a plausible scenario would be a curtailed ability to resume oil and natural gas exports following the transition.
- **SEVERE LOSS OF CAPACITY:** government revenues decline by approximately 35 percent. Here, the plausible scenario would be a partial loss of oil and gas export revenues, failure to arrange sanction waivers to access foreign reserves, and partial loss of tax collection capacity.
- **VERY SEVERE LOSS OF CAPACITY:** government revenues decline by approximately 50 or more percent. With this level of loss in revenue, a plausible scenario is a collapse in hydrocarbon production capacity and a halt in exports, failure to arrange sanction waivers, significant disruptions in the payment system, and significant loss of tax collection ability.

The scenarios above, per force, describe harsh budgetary conditions that pose serious challenges to any government, however, they are by no means insurmountable or unusual. bureaucracy has dealt with severe revenue fluctuations over the last four decades, and as a result, is familiar with handling potential stress scenarios. Even in the case of a “very severe” scenario, the loss of revenues would lead to budget shortfalls to the tune of \$100B USD over two years. We point out that first, the current frozen assets of Iran are between \$120B to \$150B. Second, Iran’s exports, even under sanctions, exceed \$100B per year and the country ran a small trade surplus of about \$29B in 2023. Thus, financing the potential shortfalls against frozen assets (as collateral) and exports would be feasible through international debt markets. Given rationally-founded expectations of the resumption of economic growth, participation in international trade, and integration into the global economy within a few years after the collapse of the Islamic Republic, raising funds in international

sovereign bond markets for a resource-rich country like Iran is quite feasible. As noted earlier, token loans from the United States and the European Union would alleviate international markets' concerns and facilitate this process.

## **EXPECTED REFORMS AND TASKS FOR THE TRANSITIONAL GOVERNMENT IN PHASES ONE AND TWO:**

As previously mentioned, we envision three phases for managing the government budget following the collapse of the Islamic Republic. Phases one and two, comprising roughly the first two years following the transfer of sovereignty and power, are expected to be the responsibility of the transitional government—which despite having no constitutional mandate—is expected to have legitimacy to implement certain reforms and carry out certain decisions. As a reminder:

- **PHASE ONE:** The first 100-180 days after the transitional government takes over. During this phase, from an economic standpoint, the transitional government must:
  - Assert control over fiscal and financial policy making institutions and processes.
  - Ensure the smooth operation of the payment system, thus safeguarding the continuity of governmental services, maintaining the integrity of government's operations, preventing the collapse of private consumption, and avoiding widespread bank runs that may severely affect the financial system (refer to the banking chapter in this document).
  - Start negotiations with foreign governments, global policy institutions, and financial markets swiftly to ensure access to financing if the need arises.
    - Iran has not used any of its IMF resources since 1962. Currently, it has about \$5B in special drawing rights (SDR) and could apply for loans that could be used to stabilize the banking sector or the payment system in general.
  - Restart exports of oil and natural gas and make all possible attempts to ensure access to all export revenues as fast as possible.
- **PHASE TWO:** Following phase one, the transitional government must:
  - Oversee the national referendum to determine the future political system, hold the constitutional convention election, hold the referendum for the new constitution, and oversee the first parliamentary and executive general elections, before ceding power to the first elected government.
  - All the while, it must discharge the usual government services and spearhead reforms that do not require a constitutional mandate.
  - This period may take between one to two years.
  - The transitional government is expected to deliver (or make significant progress in) partial to full sanctions relief, make progress in joining FATF and other financial transparency conventions, and normalize/establish functioning relations with relevant foreign countries, international institutions, and financial markets.
  - It must make progress in assuming custodianship of state-owned and quasi state-owned enterprises as well as collect information and lay the foundations for reparations and privatizations (see the relevant chapter in the document) that will follow the constitutional referendum.

We envision the transitional government operating within a tried and tested monetary and exchange rate policy for a small open economy. To curb chronically high inflation, we expect the reorganized, reformed, and independent Central Bank of Iran (CBI) to implement aggressive monetary policies, which require considerable freedom in setting interest rates (refer to the banking chapter in

this series). At the same time, there are legitimate concerns regarding liquidation and channeling of illegally gained assets along with capital flight by the Islamic Republic cronies. As a result, at least until the legal cases regarding corruption and illegal financial activities of quasi state-owned entities and Islamic Republic cronies are settled, the transitional (and even the elected) government must impose limits to cross-border capital movements for an extended period of time (see the chapter on financial markets). In addition, the rationale for using foreign reserves to defend an artificially “strong” rial is weak. The artificially “strong” rial is a signature practice of the Islamic Republic that has been extensively commented on and has led to extensive economic distortions.<sup>10</sup> Thus, we advocate for market-based, free floating or crawling peg exchange rates, an independent monetary policy mandated to curb inflation, and capital controls until both the real and the financial markets within the Iranian economy are stabilized.

During the first phase, the government may need to raise funds domestically, using the existing financial institutions, through issuing debt and requiring the financial institutions to hold these debts—a common practice in fiscal distress episodes (for example, see Chari et al, 2016).

The transitional government can—and indeed should—start streamlining and reorganizing the administrative state, which will have important cost-saving implications. Among such actions, we consider the following to be both legitimate and desirable:

- Consolidation and drastic reorganization of the conventional armed forces and the IRGC.
- Consolidation of the police force and several paramilitary law-enforcement entities, as well as drastic reorganization of the latter.
- Consolidation and drastic reorganization of the security and intelligence entities.
- Dismantling various budget-funded religious entities dedicated to indoctrination and propagation of the Islamist ideology of the regime. They include, but are not limited to:
  - Imam Khomeini Relief Committee
  - The Supreme Council of Seminaries
  - The Joint Service Center for Seminaries
  - Islamic Propaganda Organization
  - Policy Coordination Committee for Women’s Seminaries
  - The Secretariat for the Supreme Council for Cultural Revolution
  - Khorasan Seminaries’ Planning and Management Council
  - The Martyrs’ Foundation
  - Al-Mustafa University
  - IRIB (Start by closing down the foreign language branches, reorganize and trim the domestic operation with the ultimate goal of privatizing all or the bulk of this entity)
- The consolidation and potential dismantling of several ministries and budget-funded agencies. These efforts will undoubtedly take a while and likely can only be completed in phase three. However, the process could, and indeed should, start in the second phase. Examples include:

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<sup>10</sup> Refer to <https://www.fereydoun.org/reflections/multi-rate-currency>.

- Merging and drastically reorganizing ministries of Culture and Islamic Guidance and Cultural Heritage, Tourism, and Handicrafts.
- Dismantle the Ministry of Sports and Youth
- Merging the Ministry of Oil and the Atomic Energy Agency with the Ministry of Energy. Drastically reorganizing and right-sizing the resulting body.
- Substantially downsizing the national radio and television agency and privatizing the entity as soon as feasible.
- Reorganizing the Ministry of Education, consolidating the educational mandates of Ministries of Science and Technology and the Ministry of Health with the Ministry of Education.
- Dismantling the National Center for the Supervision of Cyber Space, the Expediency Council, the Guardians' Council, and the Assembly of the Experts, among others.
- Reorganizing and streamlining the Ministry of Science and Technology as a non-cabinet, largely independent and nonpartisan organization, dedicated to funding research. Potentially merging the Patent Office with this entity as well.
- Consolidation, reorganization, privatization, and potential dismantling of “foundations,” “endowments,” and state-owned or quasi state-owned enterprises, as discussed in the privatization chapter. The transitional government must maintain a realistic and agile stance regarding these entities. Some need to be placed in receiverships or custodianships, awaiting privatization upon receiving a constitutional mandate, when the elected government assumes power. Others, such as the IRGC or other security service-linked assets and entities (such as defense companies) must be immediately seized on the grounds of national security. Their status shall be determined by the elected government.
  - In general, assets of various Islamic Republic-linked entities and institutions should be placed in temporary government control, though not necessarily government ownership.
  - The menu of various forms of government control (custodianship, receivership, or outright nationalization) should match realities on the ground. In general, nationalization—and the resulting budgetary pressures of this approach—must be avoided as much as possible.
- Streamlining the government payment system, moving away from the current fragmented government banking arrangement that hinders effective cash management and control over cash balances. For example, studies such as Fainboim Yaker and Pattanayak (2010) recommend implementing a treasury single account (TSA) system. Such a model both assists better cash management and lowers borrowing costs for the government.

## **REFORMS AND TASKS FOR THE ELECTED GOVERNMENT IN THE THIRD PHASE:**

Following the conclusion of the constitutional convention and the inauguration of the first elected government—provided that the national referendum results in a conventional liberal-democratic or market-oriented political order—the task of implementing fundamental fiscal and budgetary reforms starts in earnest. Among these reforms, one must count an overhaul of social security, public health, and education systems, as well as the sprawling transfer payments and subsidies network that account for the lion’s share of the budget. These programs are—by conventional measures—in deep crisis. The pension reform and healthcare chapters in this handbook provide specific recommendations to this end. With a constitutional mandate to support its actions, the elected government must proceed with privatizing state-owned and quasi-state-owned industries and use the proceeds to fund accumulated shortfalls. The privatization chapter in this handbook lays out the proposed process for this task.

The current Iranian state under the Islamic Republic is bloated, unresponsive, and burdened with enormous amounts of red tape.<sup>11</sup> It has poorly trained, unproductive personnel with low morale and little incentive to perform at a globally reasonable standard. The state structure must be reformed to attract and retain a dedicated and well-trained body of professional personnel. In addition, we advocate for a service-focused, responsive, and agile government and hence, budgeting process, that responds to the fiscal realities of the economy and serves the population better. We recall that Iran is undergoing a notable aging of its population and the government—and by extension the budgeting process—must be ready to address the challenges of this process (refer to the healthcare and pension reform chapters).

The Islamic Republic is a deeply corrupt system. In 2023, Transparency International ranked Iran 149 out of 180 countries that they consider in their annual corruption perception index (CPI).<sup>12</sup> Thus, Iran ranks lower than most emerging and frontier markets, including most Latin American and many sub-Saharan African countries in this respect. More pressingly, Iran also ranks lower than her Persian Gulf-region neighbors, which negatively impacts the ability to attract international investments. Given the entrenched, endemic, and extremely high levels of corruption that permeate all levels of the government, a concerted effort needs to be made to address this very serious issue.

Addressing these problems requires reforming the pay and benefits structure for government employees to incentivize better performance for current employees, attract higher quality talent, and disincentivize corrupt behavior. Right-sizing the government and reforming the defined-benefit social safety net programs described in the healthcare and pension reform chapters frees up financial resources that could be used to achieve these goals.

The elected government should plan and implement a staged but rapid transition from a crude oil revenues-funded budget to an entirely tax-funded budget in the third phase.<sup>13</sup> A transition to a tax-funded budget necessitates fundamental tax reforms. The tax collection process must be updated and modernized. Several countries have attempted such reforms in recent decades. International accounting and consulting firms have accumulated substantial know-how and expertise in this respect, and Iran should tap into this pre-existing experience and knowledge rather than reinventing the wheel.

A paramount goal for any responsible government in phase three should be revitalization of the Iranian economy and revival of economic growth. An important contributor to such efforts is a growth-oriented corporate tax structure. The fundamental idea is to raise notable tax revenues from a robustly expanding economy rather than taking a large share of a stagnant one. The goal is to fund the government by taxing the income accrued to all factors of production optimally. Furthermore, the intention is to both incentivize robust long-term investment by the domestic private sector and attract a healthy stream of foreign direct investment (FDI). Thus, a simple streamlined tax code that incentivizes compliance, investment, saving, and risk taking is an absolute necessity. On the other hand, Iran is a resource-rich country. We expect revenues from the energy and other natural resource sectors to make a significant contribution to Iran's GDP for decades to come. Thus, the corporate tax code should be up to international standards, easy to comply with, and feature as few loop-holes as possible. In addition, corporate tax rates should be set competitively—both globally with respect to peer and neighboring countries—to incentivize domestic investment, FDIs, and compliance.

Many neighboring and peer countries such as Bahrain, Iraq, Qatar, and the United Arab Emirates have a two-tier corporate tax system that taxes the revenues of companies active in the energy sector more than other corporate revenues.<sup>14</sup> Since we envision privatizing the oil and natural gas sectors (see the privatization chapter), a corresponding corporate tax scheme is appealing, as it simultaneously maintains a revenue stream for the government without subordinating the energy sector to government control. While we emphasize

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<sup>11</sup> Recall that the state employs about 2.5 million people (excluding the armed forces), but cannot provide basic services or respond to frequent natural disasters such as wildfires and earthquakes.

<sup>12</sup> See [link](#).

<sup>13</sup> In 2010, oil revenues accounted for as much as 80 percent of the budget. This number has declined in recent years as oil revenues declined due to factors such as international sanctions. In addition, the government has renewed efforts to wean its finances from oil sales.

<sup>14</sup> Norway is another oil exporter that uses a two-tier corporate tax system. See the following for Bahrain ([link](#)), Iraq ([link](#)), Norway ([link](#)), Qatar ([link](#)), and the UAE ([link](#)) for more information.

competitive corporate tax rates in all sectors, they should be set sufficiently high in order to generate a substantial part of budget funding.

The two-tier taxation could be combined with a destination-based cash flow tax (DBCFT) for corporate earnings. DBCFT is a type of taxation system where businesses are taxed based on the location of consumption, rather than where production or sales take place, thus the taxation target is the destination of goods and services—i.e., where they are consumed, rather than where they are produced or sold. This concept contrasts with the traditional "origin-based" tax systems, where businesses are taxed based on where they are located or where production occurs.

The DBCFT is generally focused on taxing the cash flow of businesses—revenues from sales minus the costs of production or acquisition of goods and services—rather than profits. In addition, it can simplify accounting by eliminating the need to account for depreciation or amortization, which are common in traditional profit-based taxation.

In a DBCFT system, exports are generally exempt from taxation. This makes exports more competitive in international markets, as businesses can deduct the cost of producing or acquiring the goods or services that are sold abroad. This is different from traditional profit taxes, where exports may be subject to the same tax rate as domestic sales. On the other hand, imports are subject to the tax because they are consumed within the country. This is a key feature, as it effectively makes imported goods and services more expensive relative to domestic products, which can encourage domestic production and consumption.

One of the defining characteristics of the DBCFT is the so-called "border adjustment." This means that businesses can deduct the cost of production when they sell goods for export, while they must add the cost of imports to their taxable base. This helps level the playing field between domestic and foreign products. This system is generally applied at the business level, not at the individual or consumer level. It targets corporate income rather than individual income, and it focuses on the movement of goods and services, rather than the income generated by the business. Furthermore, at the corporate level, it eliminates the incentives to avoid taxes by sheltering profits and shifting assets offshore.

In principle, a DBCFT tax system encourages exports and discourages imports. Since exports are exempt from taxation, businesses have a stronger incentive to sell goods abroad, potentially improving the trade balance. Meanwhile, by taxing imports, the system implicitly encourages consumers and businesses to purchase domestically produced goods, which could boost local industries without using explicit trade barriers. Such a system simplifies taxing, because the cash flow-based approach can simplify accounting by focusing on actual revenue and costs rather than dealing with complex and indirect profit-based calculations, depreciation, or transfer pricing issues.

A DBCFT system faces certain challenges. A DBCFT could conflict with World Trade Organization (WTO) rules, particularly regarding border adjustments. While some countries, like the United States, have argued that border adjustments are compliant with WTO rules, there is considerable debate about whether a DBCFT could trigger trade disputes or retaliatory tariffs. Iran is currently not a WTO member. But commencing membership negotiations must be a top priority for both the transitional and the elected governments. Adopting a DBCFT system may complicate these negotiations and may require certain adjustments.

In theory, the maximum benefits of a DBCFT system occurs when a country adopts the system and other countries do not: domestic businesses may have a tax advantage when competing in international markets, since exports are not taxed. If major trading partners either adopt DBCFT systems of their own or retaliate, realized benefits are substantially smaller. Iran has been largely cut off from international trade. Thus, the risk of retaliation against adoption of a DBCFT system after the transition is significantly less prominent than for countries that are actively engaged in global trade networks.

The reliance on cash flows rather than profits might cause fluctuations in tax revenue, especially in industries with high capital expenditures or those in cyclical sectors. Cash flow taxation does not necessarily smooth out variations in earnings. Due to their

reliance on crude oil export revenues, Iranian government finances have been subject to considerable volatility. Prominent examples include the severe crunch following the collapse of oil prices in the mid-1980s and the notable boom between May 2005 and June 2008, roughly corresponding with Ahmadinejad's first term. Both events led to years of macroeconomic instability in their wake. Therefore, maintaining government revenue stability—and hence general macroeconomic stability—is an important concern for both transitional and elected governments.

A salient concern about a DBCFT system is the impact on consumers. While it may encourage domestic production, the increased taxation on imports could lead to higher prices for consumers, especially for goods and services that are heavily reliant on imported inputs and intermediate goods. This concern is less prominent for Iranian consumers. Iranian businesses are generally cut off from international trade due to perpetually elevated country risk, sanctions, and political risks. In addition, the Islamic Republic imposes exorbitant import taxes and implements various protectionist measures that keep imported goods prices substantially above global average and a drag on consumers' purchasing power. In practice, implementation of a DBCFT system with tax rates comparable to global standards of peer countries may effectively lower trade barriers and help Iranian consumers.

In addition to the tax system, the general business environment in Iran is difficult to navigate. The Islamic Republic imposes various distortionary tariffs on imports, various limitations on exports, and frequently intervenes—rather heavy-handedly—in markets. The private sector suffers under the heavy burden of red tape and an outdated regulatory structure. Various international reports rank Iran in the bottom tercile of ease of doing business league tables.<sup>15</sup> These problems have forced many Iranian entrepreneurs to register their companies in neighboring countries with significantly lower regulatory burdens, such as the United Arab Emirates, Turkey, or Oman, among others. Convincing these entrepreneurs to repatriate their earnings and register their companies domestically is an important task for the transitional and the elected governments. Perhaps a tax holiday for companies that relocate back to Iran is a solution. Moving forward, the government must distinguish between true foreign investors and establishments with a foreign registration but majority Iran-based revenues. Removal of trade barriers, such as tariffs and export controls, is another top priority for the government to encourage international trade. Given the severe repression of domestic demand and exclusion from export markets, the loss of government's revenue from reducing these barriers is more than likely to be offset by the expansion of trade volume.

Iran collects income taxes from workers. Like our recommendations for corporate tax policy, we believe that income taxes should be easy to implement, low enough to incentivize effort, engagement, participation, and compliance, and high enough to generate revenues to fund the government. The goal is to minimize tax evasion while encouraging effort and maximizing labor supply. At the same time, we believe that maintaining social cohesion requires that a degree of progressive taxation of income needs to be maintained. We believe that the tax system should encourage saving and investment, and thus propose to shield them as much as possible. One avenue is to keep savings exempt from taxation. Instead, we propose taxing consumption progressively, through mechanisms such as value-added taxes (VAT).<sup>16</sup>

VAT, which has been in implementation since 2008 in Iran, is a type of indirect tax that is levied on the value added to goods and services at each stage of production or distribution. In other words, VAT is a consumption tax that is charged to the consumer but collected incrementally at each point in the supply chain. Taxing consumption lowers the tax burden on people in the lower income deciles, who earn less and thus also consume less. More technically, taxing consumption is a good instance to enforce progressive taxation, since marginal utility of consumption is lower for high-income taxpayers. Thus, the idea of fairness in taxation is better served. VAT is widely used around the world, particularly in Europe and many parts of Asia and Africa. Different countries have different rates and rules about VAT, and some goods or services might be exempt or taxed at reduced rates. Currently, the VAT rate in Iran is 9 percent, many consumption categories such as essentials, healthcare, and educational services are exempt. Overall, enforcement and coverage remain suboptimal.

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<sup>15</sup> As an example, the World Bank ranked Iran 126 out of 190 countries in, see [here](#).

<sup>16</sup> As mentioned earlier, a DBCFT taxing regime may cause friction with international bodies or trading partners. A VAT system may reach the same goal, albeit with more complexity.

A malign feature of contemporary taxation practices of the Islamic Republic is a myriad of wealth taxes imposed on the population. These wealth taxes are unpopular as they are levied on nominal asset values amid high and persistent inflation, thus imposing a heavy burden to taxpayers as the nominal value of their assets rise, leading to ever increasing taxes levied on unrealized gains. Examples include both high real estate sales, property, and estate taxes, to name just a few. Such taxes are not pro-growth and depress asset acquisition and accumulation of capital. We propose outright elimination or, at the very least, drastic cuts to these taxes.

A crucial goal for a growth-oriented tax and legal system is managing risk-taking by entrepreneurs. The current treatment of bankruptcy, a natural outcome of risk-taking, in Iranian penal and business codes is unnecessarily harsh and punitive. Thus, this document advocates a tax code that reduces the penalties for personal and corporate bankruptcy laws to align them with modern norms, with an eye toward encouraging calculated and responsible risk-taking. In addition, to enhance the ability of Iran in attracting FDI and human capital in the global marketplace, we envision legal provisions in the tax code that encourage FDI flows and recruiting international talent through favorable tax treatment. Selective recruitment of high caliber international talent can provide us with a model for developing our own talent, which is the ultimate goal for securing organic, generational prosperity.

The suggested reforms must simplify Iran's current archaic taxation system and increase its collection capacity and efficiency. However, they could still require significant changes to the existing tax administration system, Iranian National Tax Administration Agency (INTA), particularly since they require substantially higher levels of efficiency and transparency. That said, a transition from the Islamic Republic to a liberal-democratic political order is the optimal time to implement the inclusive, market-oriented, and pluralistic reforms and institution-building efforts advocated by among others, Baumol et al. (2007), Acemoglu and Williams (2012, 2019), and Zingales (2012).

Wasteful and inefficient economic central planning, in various forms, has been a salient feature of Iran's fiscal and development policy making since the 1980s, and must be reformed. The planning and budget organization (PBO) has designed several 5-year development plans since the late 1980s. These 5-year plans have proved to be ineffective, costly, wasteful, and in certain areas (for example water management and hydroelectric production) outright harmful. They have led to inefficient and often wasteful allocation of resources, primarily through subsidies, cheap loans, tax breaks, and various protectionist shields. The planning process is overtly prone to political interference, favoritism, and rent-seeking behavior. As an example, direct interference by Ali Khamenei—the second Supreme Leader of the Islamic Republic—to prioritize the largely traditional and labor-intensive agriculture sector in successive 5-year plans since 1990 is a major contributor to Iran's disastrous water crisis and large-scale environmental degradation.<sup>17</sup> We believe that citizens and market participants are better positioned than bureaucrats to identify and exploit economic opportunities, leading to faster development. Thus, to empower the private sector and reward private sector initiatives, we recommend abandoning central planning, and scaling down industrial policy and government-directed development initiatives. We recommend that support measures for private industry, if absolutely necessary, must be provided sparingly and on a case-by-case basis, and through the Ministry of Industry. Traditionally, PBO has been responsible for the budgeting process, and has developed expertise in this area. We recommend merging this function of the organization with the reformed and streamlined department of the treasury or the Ministry of Fiscal Affairs.

All modern states invest in infrastructure and human capital. Given years of underinvestment in infrastructure and especially in human capital under the Islamic Republic, we expect the elected government to extensively engage in such activities. To ensure public oversight and consent, funding for these projects must be allocated from the general budget and tax-funded as much as possible. The objective is to subordinate such executive branch expenditures to civil and parliamentary oversight to protect public funds from misappropriation, misallocation of resources, and corruption, as much as feasible. Furthermore, we envision an expansion of state-backed research and development (R&D) expenditures in basic science and technology in a 7 to 10-year period to about 2 percent of GDP. To this end, we advise establishing a government agency modeled after the Swiss National Science Foundation (SNSF) or the United States' National Science Foundation (NSF) but predominantly focused on growth-enhancing research for the first 10 to 15 years.

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<sup>17</sup> This issue is extensively covered in the second phase of this project.

A responsible state must maintain fiscal discipline. Very few (typically rich) countries can maintain high public debt to output ratios without triggering financial downturns, significant slowdown in economic growth, or notable rises in effective costs of borrowing. Poor fiscal discipline is also an established contributor to high inflation rates in emerging and frontier markets. As discussed earlier in this chapter, successive Islamic Republic administrations have displayed complete lack of fiscal discipline since the 1980s. Their lack of fiscal prudence manifests in persistent and chronic double-digit inflation that afflicts Iran. Consequently, it is imperative to enforce fiscal discipline upon the Iranian state to build trust with the people of Iran and the international community, but also to rein in potential populist impulses of the future democratically elected governments. At the same time, we note the differences in the speed and the strength of national-level economic recoveries rooted in fiscal responses of governments to the Great Financial Crisis of 2008-09 and the COVID-19 pandemic that demonstrate that adherence to a strictly balanced budget—regardless of the state of the economy—may not be a prudent policy. A country may want to preserve the government’s fiscal flexibility in the face of large economic shocks.

To reconcile these seemingly incompatible concerns, we suggest a legal provision for a “cyclically balanced budget.” A cyclically balanced budget refers to a fiscal policy approach in which a government aims to balance its budget over the course of an economic cycle rather than annually. The idea is that during periods of economic growth, the government can run budget surpluses, while in times of recession or economic slowdown, it allows for deficits to support the economy through increased spending or tax cuts. The goal is for these surpluses and deficits to offset each other over the full business cycle, achieving a long-term balance. Among others, Levinson (1998) provides empirical support for this approach.

Key Features of cyclically balanced budget fiscal policies include:

1. Counter-cyclical fiscal policy: During periods of economic expansion, the government reduces spending or increases taxes to prevent overheating and inflation, generating a surplus. During recessions, it increases spending or cuts taxes, running a deficit to stimulate the economy.
2. Long-term focus: The balance is not achieved every year but across several years, aligned with the phases of the business cycle (typically lasting 5–10 years).
3. Avoid pro-cyclicality: Governments avoid cutting spending or raising taxes during a downturn, which could worsen the recession (pro-cyclical policies). Instead, deficits are tolerated when necessary to support recovery.
4. Debt management: While short-term deficits are permitted, the aim is to prevent unsustainable debt accumulation over time.

This fiscal policy approach has notable advantages. It implements automatic stabilization policies by supporting aggregate demand during downturns and preventing overheating during economic expansions. Cyclically balanced budgets allow remarkably flexible fiscal policies. They provide room for governments to respond to changing economic conditions. In addition, they encourage responsible fiscal management over the full business cycle and long-term sustainability of public debt.

In practical terms, Chile since the 2000s and Sweden since 1990s have adopted fiscal policy frameworks close to cyclically balanced budgets, tailored to their economic realities. Chile has pursued accumulating surpluses during commodity booms and allowing deficits only when the economy is below its potential output. Sweden adopted fiscal rules that target budget surpluses over business cycles. In both countries, the results are encouraging and have helped smooth economic downturns while maintaining long-term budget balances and economic stability.

To impose fiscal discipline on the state and enforce the cyclically balanced budget provision, we strongly recommend the creation of an independent, specialized, and non-partisan budgetary oversight body to regularly assess and audit budgeting processes, government expenditures, and fiscal policies. One solution is to empower the Office of Inspector General of the Nation—an organization in the Judiciary branch. Another solution is to empower the Bureau of National Accounts, currently within the Treasury, but under this scenario

is spun off as an independent organization that reports to Parliament. Alternatively, the Parliament could establish a special vehicle, with features similar to the congressional budget office (CBO) in the United States, to discharge these services.

A cyclically balanced budget also requires careful and accurate measurement of various economic cycles (business, financial, etc.) These tasks could be delegated to the statistics center of Iran (SCI), a competent and professional entity within the PBO. However, to avoid conflicts of interest and to neutralize political pressures, we believe that SCI should be spun off from PBO and reorganized as an independent and nonpartisan bureau with public oversight. An additional benefit of separating the SCI from PBO is that an independent SCI—that carries out national census—could also actively participate in determination of parliamentary districting and delegate numbers.

Finally, we must emphasize the centrality of formal and easily enforced anti-corruption procedures to be implemented immediately by the transitional and the elected governments. Otherwise, endemic and deep-seated corruption, a sad but material legacy of the Islamic Republic, will drown all efforts to restructure and refocus the government operations that are necessary for effective delivery of services to citizens. As mentioned earlier, the Islamic Republic is deeply corrupt. Tackling this problem systematically requires formal legislation and legal oversight. The (Legal Overhaul) section in the second phase of this studies various strategies to address this issue. However, implementing simple and efficient human resources procedures for detection and taking action against verified cases of illegal behavior by government employees could cement the culture of integrity and accountability early in the transition period.

## **CONCLUSIONS:**

As in any significant seismic shift, the fall of the Islamic Republic will lead to considerable disruption, presenting both significant risks and attractive opportunities. In the short term, particularly in the first few months following the regime's collapse, we could expect a slowdown in business activities, a rise in financial losses, and a decrease in international trade. All of these factors will likely affect the government's revenues.

Given the political instability and the anticipated absence of a strong mandate for the interim government, it is unlikely that they will be able to undertake a substantial overhaul of the bureaucracy and government expenditures in phase one. Therefore, it is more realistic not to rely heavily on cost-cutting measures to balance the budget in the first phase. We argue that they should start in the second phase of the transition and must be completed in the third phase, once the elected government has a constitutional mandate.

Ironically, due to sanctions, Iran has accumulated a significant currency reserve that it currently cannot fully access. Consequently, it is crucial for the government to manage Iran's foreign policy so that increased access to these currency reserves becomes feasible. This means working closely with the United States and its allies to secure a swift suspension of sanctions, while also maintaining a cooperative relationship with China, where many of these assets are held. These reserves could be sufficient to cover the budget gap. As time goes on and Iran's international trade recovers, the country's reliance on its currently inaccessible foreign currency reserves will diminish.

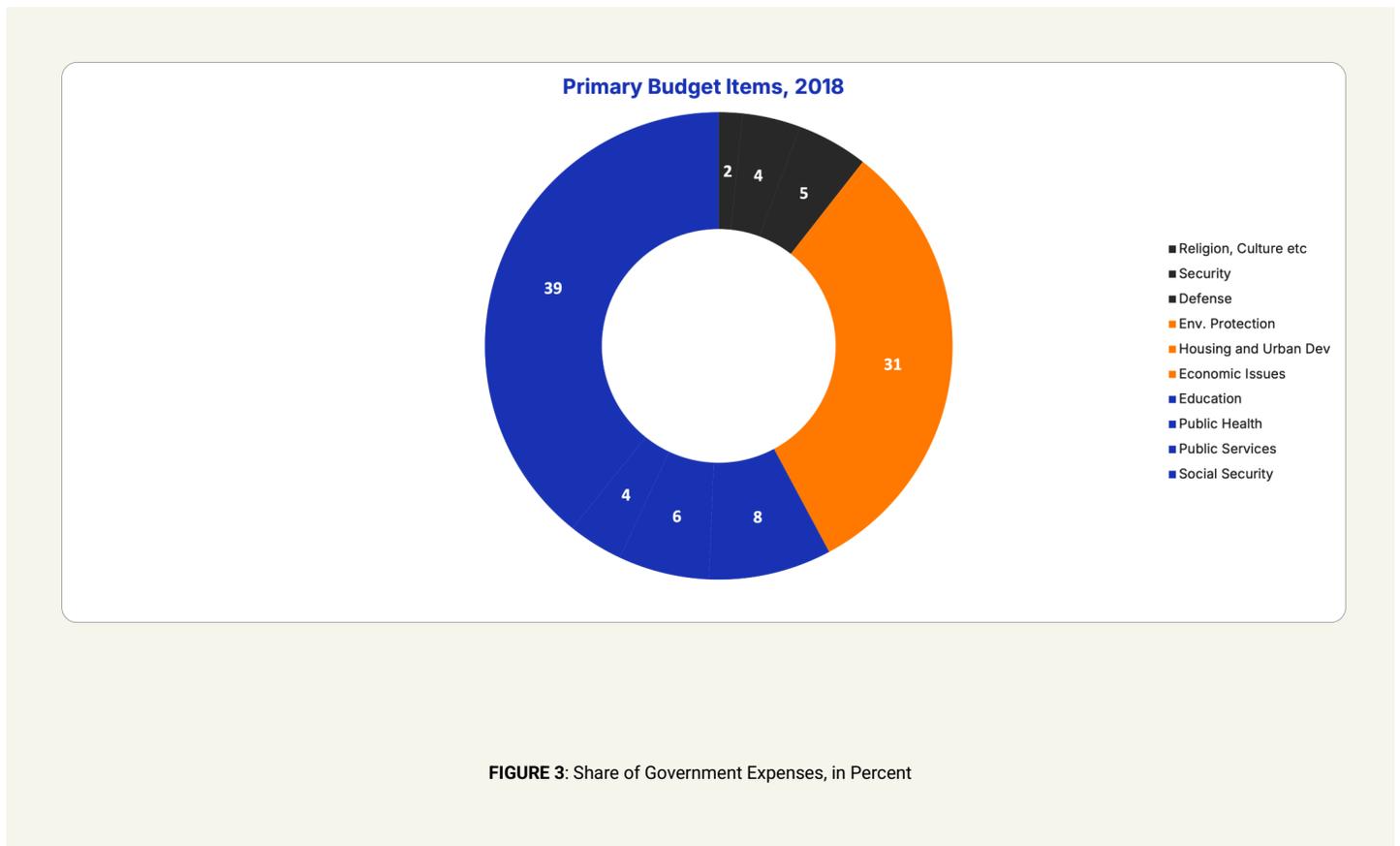
Following the ratification of the new constitution, and armed with a popular mandate, we recommend that the new elected government undertake a complete structural overhaul of the administrative state, government spending and investment priorities, and the taxation system. The goal, we believe, should be making the government focused on its core responsibilities, simplifying the tax system, lowering the tax burden where possible, and providing incentives for entrepreneurship, attracting foreign investments, and unleashing the creativity of the people.

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## Appendix:



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