

**Islamic Republic of Iran: Report on the Observance of Standards and Codes—
Fiscal Transparency Module**

This Report on the Observance of Standards and Codes on Fiscal Transparency for the **Islamic Republic of Iran** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **December 2, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Islamic Republic of Iran** or the Executive Board of the IMF.

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ISLAMIC REPUBLIC OF IRAN

Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module

Prepared by the Fiscal Affairs Department

Approved by George T. Abed and Peter S. Heller

December 2, 2002

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in the Islamic Republic of Iran in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information.

The public sector is very large and the relationships between central government, provinces, municipalities, public enterprises, state-owned banks, and *bonyads* are complex. However, since the enactment of the 5-year Development Plan covering 2000-04, the authorities have taken a number of steps to enhance fiscal transparency, especially with respect to the budget process. Important recent actions include: eliminating implicit exchange rate subsidies (a result of exchange rate unification), budgetizing other implicit subsidies including those associated with price controls, and adopting contemporary budget classification standards. The audit framework for the public sector has a robust legal framework and follows international auditing standards.

Further efforts will be needed in a number of areas before the country attains a high level of fiscal transparency. This report prioritizes the focus of future reforms as follows:

- **Clarifying the financial and management relationships within the enlarged public sector and enhancing the transparency of their operations.** Transparency would be improved by providing the central bank with greater autonomy and by separating the noncommercial and commercial roles performed by nongovernment public institutions, particularly *bonyads*. Concerning the planned privatization of nonfinancial public enterprises, it will be important that this results in a clarification of the complex relationships between state enterprises, nongovernment public institutions, and the government. There is also a need to identify, and eventually quantify, all quasi-fiscal activities, tax expenditures, and contingent liabilities.
- **Improving the quality of fiscal information.** It is essential that timely monthly fiscal reports are prepared and that they are consistent with the monetary accounts. Internal auditing should also be established. Shortening the long complementary period for closing the annual accounts is needed; this would enable the annual external audit report on budget outcomes to be published in a more timely fashion.
- **Increasing the availability, timeliness, and comprehensiveness of fiscal information to Parliament and the public.** Monthly fiscal reports should be published. A comprehensive mid-year report on budget implementation should also be prepared for Parliament and the general public.
- **Strengthening the budget process,** particularly by introducing an annually-updated medium-term macroeconomic and expenditure frameworks, rationalizing government banking arrangements, and upgrading accounting systems for tracking expenditure commitments. Moreover, all extrabudgetary expenditures from oil revenues, including those from the Oil Stabilization Fund, should be integrated into the budget process.

	Contents	Page
I.	Introduction.....	4
II.	Description of Practice.....	4
	A. Clarity of Roles and Responsibilities	4
	B. Public Availability of Information	10
	C. Open Budget Preparation, Execution, and Reporting	12
	D. Assurances of Integrity.....	16
III.	IMF Staff Commentary.....	18

ABBREVIATIONS, ACRONYMS, AND WEB LINKS

AO	Audit Organisation
BMJ	Bonyad Mostazafan va Janbazan (www.iran-bonyad.org)
BMJII	Bank Markazi Jomhuri Islami Iran (Central Bank; http://www.cbi.ir)
CA	Customs Administration (http://www.irica.org)
EBFs	Extra-budgetary Funds
GFS	Government Finance Statistics
IPO	Iran Privatization Organization
MEAF	Ministry of Economic Affairs and Finance
MPO	Management and Planning Organization (http://www.mporg.ir)
NIOC	National Iranian Oil Company (http://www.nisoc.com)
NTO	National Tax Organisation
OSF	Oil Stabilization Fund
QFAs	Quasi-Fiscal Activities
ROSC	Reports on the Observance of Standards and Codes
SAC	Supreme Audit Court
SCI	Statistics Centre of Iran (http://www.sci.or.ir)
SDDS	Special Data Dissemination Standard
SOEs	State-owned enterprises
SSO	Social Security Organization
SUs	Spending Units
TFYDP	Third Five-Year Development Plan

Islamic Republic of Iran: Basic Data

Type of government: An Islamic Republic with a unitary government.

Fiscal year: Based on a solar Hajira year, beginning on March 21, and ending on March 20 of the following year.

Population (2001): 64.6 million

GDP (2001/02): 83,6 billion US dollars

External Public Debt/GDP (2000/01): 7 percent

I. INTRODUCTION¹

1. This draft report provides an assessment of fiscal transparency practices in the Islamic Republic of Iran against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*.² The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of discussions with the authorities and their responses to the fiscal transparency questionnaire, and drawing on other available information. The second part is an IMF staff commentary on fiscal transparency in Iran.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **In some respects, the institutional coverage of “government” is considerably wider than “general government” as defined in the Government Finance Statistics (GFS) manual.** In addition to central government (which includes provinces), the annual budget includes about 500 state-owned enterprises (SOEs), the 10 state-owned banks and the Central Bank (Bank Markazi Jomhouri Islami Iran—BMJII). Of the 18 contributory pension funds, transfers to four of them are included in the annual budget. Transfers to the Social Security Organization (SSO) are particularly important, as the government supplements the contributions paid by employers and employees.^{3 4} Although the budget document therefore includes many institutions outside “general government,” it nonetheless excludes some institutional units inside “general government,” notably municipalities and extrabudgetary funds, especially the Oil Stabilization Fund (OSF) (see paragraphs 2 and 5 below).

3. **The budgets of municipalities are becoming increasingly important; they are excluded from the government’s budget.** There are 800 municipalities, established under the Municipalities Act, 1955, and for larger cities, under the Law of Organization, Functions and Elections of Islamic City Councils and Mayors, 1996. City Councils approve annual budgets and authorize local levies and charges. There are implicit contingent liabilities associated with municipal governments, as they can and do borrow (both domestically and

¹ Discussions on fiscal transparency were held in Tehran during June 17-29, 2002. The staff team, comprising Messrs. Gupta (head), Desai, and Lienert and Ms. Corbacho (all FAD) met with the Minister of Finance, his Deputies and officials from the Ministry of Economic Affairs and Finance, the Management and Planning Organization, the Central Bank, the Audit Organisation, the Social Security Organization, the National Iranian Oil Company, the Budget Committee of Parliament, and Bonyad Mostazafan va Janbazan.

² The IMF *Manual on Fiscal Transparency* (<http://www.imf.org/external/np/fad/trans/manual/>) should be consulted for further explanation of the terms and concepts discussed in this report.

³ For the SSO, contributions are: 20 percent by employers, 7 percent by employees and 3 percent by government. The other main pension funds to which the government contributes are for civil servants and for the army.

⁴ The SSO, *bonyads*, and municipalities are classified as “nongovernment public institutions.” This terminology is inconsistent with GFS, which would classify the SSO and *bonyads* (to the extent that they are holding companies) as “nongovernment public corporations” and municipalities as “general government.”

internationally), provided authorization is obtained from the City Councils and central government. Expenditures of all municipalities in 2000/01 were the equivalent of 8 percent of central government expenditures. There are 28 provinces, all of which are entirely dependent on central government transfers. Under the Third Five-Year Development Plan (TFYDP) more autonomy is being provided through recently-created provincial Councils of Planning and Development. Under these new arrangements, the mechanisms for resolving inconsistencies between provincial and national priorities are unclear.⁵

4. The roles of the executive, legislative and judicial branches are clearly defined in the Constitution. The Supreme Leader supervises all three branches. An elected President, who is head of the Executive, is the second highest government official. Following the abolition of the post of Prime Minister in 1989, the President inherited additional responsibilities, including nominating Cabinet Ministers and chairing Cabinet meetings. The President lacks veto power over the budget.⁶ The key roles of the Executive and Legislature in the budget process are described in section C (Box 4).

5. The role of other constitutional bodies in fiscal matters is not well defined. Article 110 of the Constitution defines the duties and powers of the Supreme Leader. These include delineating the country's general policies, after consultation with the Expediency Council.⁷ All laws passed by Parliament must be sent to the Guardian Council, which may ask Parliament to review legislation before it is adopted. Although there is potential for conflict, institutions under the leadership have not prevented the passing of annual budgets, nor of important tax law changes (e.g., the removal of tax exemptions provided to SOEs in early 2002). Coordination between Parliament and the Guardian Council is assisted by the attendance of Guardian Council representatives at parliamentary debates.⁸

6. There are sizeable extrabudgetary activities. A comprehensive list of extrabudgetary funds (EBFs)—legally-constituted funds whose operations are not approved in the annual budget—is not available. Known EBFs include: the OSF (see Box 1), the Employment Generation Fund, the Assistance to Cooperatives Fund, the Education Employees Reserve Fund, the Export Guarantee Fund, and special funds for rural development (Article 137 of the TFYDP). In addition, some off-budget spending is made from oil revenues before their transfer to the budget or to the OSF. Such spending is mainly for buyback arrangements and other off-budget payments.

⁵ These councils prepare provincial medium-term development plans and annual provincial budgets, consistent with national plans; propose ways to acquire new sources of income; review development and recurrent budget expenditures; and present quarterly financial reports to provincial committees.

⁶ Article 123 of the Constitution states that “the President is obliged to sign legislation approved by the Assembly ...after the legal procedures have been completed and it has been communicated to him. After signing, he must forward it to the responsible authorities for implementation.”

⁷ The Expediency Council was established in the Constitutional amendment of 1989 as the body that resolves disputes between Parliament and the Guardian Council (the 12-person body responsible for ensuring that all laws adopted by Parliament are in accordance with Islamic tenets and with the Constitution).

⁸ Attendance of Guardian Council members is obligatory when an urgent government or member's bill is placed on the agenda of Parliament (see Article 97 of the Constitution).

Box 1. The Oil Stabilization Fund

- **Established in December 2000 and managed by a Board of Trustees** comprised of the Minister of Finance, the head of the Management and Planning Organization (MPO), the Governor of the BMJII, and two members selected by the President.
- **Main objectives:** (1) to *insulate* the budget from fluctuations in international oil prices; (2) to *generate savings* to be used should oil prices fall significantly, and (3) to *support development* of private sector projects in specific sectors.
- **Source of revenues:** oil revenues in excess to those allocated to the budget, as described in the annex to the TFYDP. Parliament must approve additional transfers to, or withdrawals from, the OSF. In the 2002/03 budget, Parliament approved a rundown of OSF's balance by \$2.1 billion, to finance additional expenditures.
- **Utilization of OSF resources.** All assets are held in a foreign currency deposit account managed by the BMJII; up to 50 percent of OSF resources may be used to provide foreign currency loans to eligible private sector firms. In mid-2002, the US dollar interest rate on most loans was set at LIBOR plus 2 points, but some loans were at lower interest rates. Parliamentary approval of the projects financed by the OSF is not required; the OSF's Board of Trustees⁹ decides on utilization and priorities.
- **OSF financial position.** At the end of 2001/02, the OSF had accumulated US\$8 billion, of which \$1.2 billion had been approved for project lending.
- **Publication and audit of accounts.** Monthly reports of OSF's activities are prepared by the BMJII and sent to the Treasury and the MPO, but these are not published. The annual accounts for 2001/02 have not yet been audited by the Supreme Audit Court (SAC), although it is intended to do so and report the results to Parliament.

7. The central bank has limited independence and plays an important fiscal policy role.¹⁰ The BMJII is an affiliate of the Ministry of Economic Affairs and Finance (MEAF) and is the most important provider of publicly-available fiscal data. BMJII's operational policies are governed by the Money and Credit Council, headed by the MEAF and dominated in membership by high government officials. Until recently, the BMJII provided credits directly to finance the government's deficit. The BMJII's support is now mainly indirect, especially through its involvement in quasi-fiscal activities (QFAs)—see below.

8. Nearly all banks are state-owned and are used by the government for fiscal purposes.¹¹ Until 2001 when two private banks began operating, all banks were state-owned.¹² The financial rates of return on bank assets and liabilities are set with a great degree of specificity and remain unchanged for a given financial year. To promote agriculture, and

⁹ There are five members of the Board of Trustees of the OSF, all from the Executive branch (see Article 8 of the Cabinet Decree on the Code for Execution of the Amended Article 60 of the TFYDP).

¹⁰ The legislative basis of the BMJII is provided in the *Monetary and Banking Act, 1972*. The *Usury-Free Banking Act, 1983*, introduced Islamic banking principles.

¹¹ After 1979, all banks were nationalized under the *Banks Nationalization Act*. The *Law for the Administration of Banks* was also adopted in 1979.

¹² There were 10 state-owned banks, with 6 commercial banks (one owned by the SSO) and 4 specialized banks.

to a lesser extent exports, industry, mining, and housing, rates of charges on bank facilities for these sectors are set at rates lower than those for trade or for services.

9. There are substantial quasi-fiscal activities, although exchange rate unification in March 2002 has eliminated an important source for these. QFAs are important in the banking sector and have also arisen from government's pricing policies (Box 2).

Box 2. Quasi-Fiscal Activities

QFAs are activities whereby public financial institutions and enterprises achieve fiscal policy objectives, affect the overall public sector balance, but do not impact on the budget deficit as conventionally measured. The main QFAs are as follows:

Financial sector QFAs:

- Directed credits: bank loans to specific sectors and SOEs.¹³
- Subsidized lending via directed credits (a long-standing policy).¹⁴
- OSF's granting of loans bearing below market interest rates to selected borrowers (a new off-budget activity).
- Provision of bank credit to cover the deficits of certain SOEs.
- Bank's obligations to hold a high level of unremunerated reserves.¹⁵

QFAs using public enterprises:

- Large implicit subsidies (estimated to amount to 4-6 percent of GDP in 1999) from the pricing of refined petroleum products for the domestic market at prices below international levels.
- QFAs associated with the regulated prices for electricity and for water.
- Social expenditure effected through the largest *bonyad* (see Box 3).

10. The boundaries between the public sector and private sector are blurred. This arises from the categorization used by the government for entities with different degrees of public ownership. Although the government may own less than 50 percent of the equity in some enterprises, it may exercise considerable influence over the companies' management. Additionally, some "autonomous" public entities may hold other entities that are 100 percent state-owned (for example the SSO owns one of the 10 state-owned banks). Finally, within the

¹³ Although bank credit is still directed towards specific sectors and enterprises, under the TFYDP, the share of such credit in total bank sector credit is projected to diminish.

¹⁴ Beginning with the 2002/03 budget, subsidized interest rates have, in principle, been reimbursed by the budget, in line with the TFYDP. It is unclear whether this has been done universally. For instance, under Article 173 of the TFYDP, the government is allowed to allocate credit at below market rates to the Ministry of Defense.

¹⁵ Banks reserves absorb about 16 percent of deposits. This is high by international standards. Reserve requirements are differentiated by maturity and type of deposit, making it difficult to discern the extent of the implicit tax on banks.

public sector, foundations (*bonyads*) are important institutions with both a commercial and social role (Box 3).

11. Government regulations have tended to favor state enterprises and *bonyads*. The main laws that regulate the nonbank private sector are: tax and customs laws, labor laws/regulations, the commerce law, and export and import regulations. In general, there has been no open formal process for assessing the quality of proposed new regulations and for periodically reviewing existing regulations, which were often complex and discriminatory. Until recently, SOEs and *bonyads* received favorable tax treatment, as well as for foreign exchange allocation.

Box 3: The Foundations (*Bonyads*)

***Bonyads* have existed for a long time.** After 1979, the assets of former leaders and of the businessmen and landowners who left Iran were seized and handed over, after Court rulings, to some existing and newly established foundations. Major *bonyads* are under the direct oversight of the Supreme Leader.

***Bonyads* may perform not only social assistance functions but also economic activities.** Some benefit from government support in the form of budget transfers, and preferential access to credit. Some are also financed through charitable contributions. Until the beginning of the TFYDP, all *bonyads* were exempted from income tax. However, effective 2002/03, they will be subject to the same tax code as other enterprises.

The most diverse and largest foundation is the *Bonyad Mostazafan va Janbazan* (BMJ, Foundation of the Oppressed and Injured). BMJ was established by the order of late Imam Khomeini on the basis of Articles 45 and 49 of the Constitution. It is supervised by the leader of the Islamic Revolution and administered by a president appointed by the supreme leader. BMJ provides social assistance to 140,000 families of war veterans, including housing, health and education services. BMJ also provides loans to the self-employed at below market interest rates through a credit institution with an estimated \$400 million in public deposits. BMJ employs 60,000 workers and manages around 400 enterprises involved in six economic sectors, with an annual turnover of around \$3.5 billion. Each affiliated company has a Board of Directors and is managed on a commercial basis. The foundation's website describes its extensive commercial activities in major sectors of the economy. In recent years, BMJ has been active in the purchase of shares of companies listed in the Tehran Stock Exchange including those of privatized SOEs.

The government considers *bonyads* as nongovernment public enterprises. This is consistent with the Constitution. Article 45 states that "...public property recovered from usurper shall be at the disposal of the Islamic government for it to utilize in accordance with the public interest." Article 49 states that "The government has the responsibility of confiscating all wealth accumulated through usury, usurpation, bribery, embezzlement, theft, gambling, misuse of endowments..."

The activities of major *bonyads* supported by budget transfers are audited by the Audit Organisation (AO). Under the 1983 Act, the AO is authorized to "perform the annual audit of the accounts of governmental institutions and enterprises, banks and other public organizations and their affiliated organizations, such as the Mostazafan and the Shahied Foundations under the supervision of the government..." In 2000/01, the AO audited the accounts of 498 enterprises controlled by the BMJ and other *bonyads*. These audited reports on activities funded by the government are available to the SAC and a consolidated report of these, as well as those of the SOEs, is made available to Parliament and to the public. Audit reports on the remaining activities of *bonyads* (those not supported by the government) are forwarded to the office of the Supreme Leader, but not to the government or Parliament.

12. Concerning privatization, the authorities are developing a new permanent legal structure, to clarify the process and to address transparency concerns. The TFYDP for 2000–04, which was adopted by Parliament as a Law, currently provides a legal framework for privatization. In 2001, the Iran Privatization Organization (IPO) was set up under the aegis of the MEAF. Amongst its tasks, the IPO is drafting a permanent Privatization Law to replace the TFYDP when it lapses at the end of the Plan period (end-2004). This law is expected to clarify difficulties in interpreting relevant articles of the TFYDP, such as the categorization of saleable SOEs into “small,” “medium” and “large” enterprises.¹⁶ In the annual budget, the amount of projected privatization revenue is shown on a net basis, as Article 19 of the TFYDP envisages that up to 50 percent of the gross revenue is to be paid to the shareholding company of the state enterprise, to cover the costs of restructuring.

13. Fiscal management is governed by a number of laws, some of which are in need of revision. Articles 51 to 55 of the Constitution contain legal provisions that, if fully implemented, enhance the transparency of fiscal management. These relate to the legal basis of taxation, expenditure, and the annual budgets; all revenue collections being deposited at the central treasury; and the establishment of the SAC. Laws to implement these constitutional requirements include: the National Planning and Budget Law (1972), the law establishing the MEAF (1974), the Government Accounting Law (last amended 1987), and the TFYDP. These laws specify the various aspects of planning and budget preparation; expenditure execution including procurement, control, and payment; government accounting and the consolidation of annual accounts and their submission to the Legislature. The older laws are not fully consistent with the TFYDP, which emphasizes the need for the State to withdraw from productive activities. Also, the intended movement towards program-oriented budgeting and greater accountability requires new legal provisions. In order to facilitate reforms in the budget process, a joint committee between parliamentary representatives and government officials from the MPO has been established.

14. Clear conditions exist if Parliament wishes to change the annual budget proposed by the President. Article 75 of the Constitution requires that members’ bills and proposals, or amendments to government bills proposed by members, which entail a reduction in revenues or an increase in expenditure be introduced in Parliament only if the means for compensating for the revenue decrease or for meeting the new expenditure are also specified.

15. Several central agencies are involved in fiscal management and coordination between these appears to be relatively good. The formulation of five-year plans and the annual budget is carried out by the MPO, an agency under the Presidency. It is also in charge of monitoring program implementation. The MEAF is responsible for the administration of revenue and for government accounting. Regarding expenditure, the MEAF is in charge of exercising financial control and of ensuring compatibility with the Government Accounting Law. The Treasury—in the MEAF—authorizes the opening of spending units’ (SUs) bank

¹⁶ Also, a new Foreign Investment Law was approved in May 2002.

accounts. The BMJII's responsibilities include maintaining government bank accounts, and managing the deposits of the OSF. As a public service, the BMJII prepares and publishes fiscal reports.

16. The legislative basis for taxation and administrative procedures are relatively clear, but they may not always be observed in practice. Article 51 of the Constitution states that no form of taxation may be imposed except in accordance with the law and that the law determines provisions for tax exemptions and reductions. The main laws are the Direct Tax Act 1988,¹⁷ ad hoc taxes on consumption (which are planned to be replaced by a VAT, for which a law has already been drafted), the Excise Tax Law 1995, specific taxes adopted in the annual budget law, and the Customs Law (a new draft has been prepared to replace the 30-year-old law and to simplify the multiplicity of duties and charges on imports). Tax compliance has been poor particularly in the case of SOEs. For instance in 2001/02, the stock of tax arrears exceeded 1 percent of GDP. The tax system was simplified when some "nuisance" taxes were eliminated in early 2002.¹⁸ There have been efforts to reduce discretion in self tax assessments that can now be certified by chartered accountants. The National Tax Organisation (NTO) was established by law in 2001 (Article 59 of the TFYDP); it has prepared tax guides for taxpayers and created taxpayers' services offices to answer written and telephone queries from taxpayers. Similarly, the Iran Customs Administration (CA) has prepared a number of brochures to assist importers.

17. Mechanisms exist for promoting ethical behavior of public servants. There is no uniform code of ethical standards. However, ministers and senior civil servants are required to declare their assets. In addition, a high-level disciplinary committee exists in the MEAF to sanction tax, customs and treasury officers for serious breach of conduct. More generally, an anti-bribery law is in place.

B. Public Availability of Information

18. The budget presents the main budget estimates for the current period but not for the years following the budget. It reports the outturn and budget figures of preceding fiscal years of the TFYDP, which covers 2000-04. For the first year of the TFYDP, there was an assessment of the previous year's fiscal outturn in the President's Report to the Parliament. The budget discussions are broadcast live.

19. Contingent liabilities of the central government are not included in the budget. There is no published estimate of contingent liabilities including those arising from government guarantees of SOEs' debt. The central government also faces implicit contingent liabilities stemming from municipalities' debt obligations and insurance of depositors in state-owned banks (in the absence of deposit insurance arrangements). Following the exchange rate unification, letters of credit and other guaranteed debt previously valued at the

¹⁷ Major modifications to this Law—including significant reductions in marginal tax rates and a simplification of the tax structure—were made in February 2002.

¹⁸ These were mainly certain property and land taxes that raised little revenue.

official exchange rate to SOEs are to be valued at market exchange rates should the guarantee be called; the 2002/03 budget included a specific amount for this revaluation.

20. Estimates of tax expenditures are not contained in the budget. The extent of tax exemptions (both to *bonyads* and some SOEs) has been large. In February 2002, Parliament approved legislation that reduced some tax exemptions, but introduced new ones. Exemptions are now based on the activities performed (e.g., new investments or reinvestment of profits) and location (e.g., companies in poor regions), rather than on the private/public status of the enterprises. It is unclear whether these changes will make it easier to quantify and report on exemptions. The simplification of the company income tax structure, as from 2002/03, should improve transparency in the tax system. Additionally, *bonyads* are now subject to income tax, at the same rate as other legal entities. Some exemptions from personal income tax have been eliminated, although the police and military personnel continue to be exempt, and civil servants are taxed at a reduced rate of 10 percent. Moreover, tax exemptions continue to be accorded to the agricultural and export sectors. Customs exemptions are provided to industries in the manufacturing sector.

21. The cost of some subsidies is included in the budget. The 2002/03 budget includes subsidies for approximately 1 ½ percent of GDP in addition to those for exchange rate operations. The subsidies are provided for certain goods and on loans at below-market interest rates.¹⁹ Price subsidies have decreased as a percent of GDP in recent years.

22. Information on part of the gross public debt is published. Data on consolidated external debt is published by the BMJII, classified by maturity. The MPO reports data on only part of the domestic debt, including gross public debt of the government and SOEs to the BMJII, but excluding any bank and private holdings. There is no published data on the domestic debt of lower levels of government. The BMJII releases data on assets and liabilities of the banking sector. Information on government financial assets is not available.

23. Selected fiscal data can be found on the websites and in publications of the BMJII, the MPO and the Statistics Centre of Iran (SCI). Annual data on the budgets of the government and SOEs and on public debt are provided in the Bulletin of Socio-Economic Statistics, published by MPO. Quarterly data are available in Economic Trends, published by BMJII. This report is normally disseminated with a two-month lag and provides disaggregated data on budget revenues from oil, major tax categories and other revenues. The published data on budget expenditures are, however, presented as two global aggregates—current and development expenditures—and do not provide economic or functional dimension of the expenditures.²⁰ This publication also includes data on assets and liabilities of the central bank as well as of the financial public sector. The yearly bulletin of the BMJII,

¹⁹ Articles 46 and 47 of the TFYDP stipulate that the government should subsidize the price of wheat, rice, vegetable oil, sugar, cheese, medicine, dry milk and agricultural inputs such as fertilizer, pesticides and seeds.

²⁰ The Treasury maintains separate records of funds transferred for current and development expenditures, facilitating their separate presentation in BMJII reports. Disaggregated expenditure data are available only at the spending agencies, which maintain primary record of expenditure operations—such data are not published.

Economic Report and Balance Sheet, does provide disaggregate information of expenditures, including on defense. The Statistical Yearbook of the SCI compiles time series of annual data provided by the MPO.

24. **There is no pre-announced calendar for the release of fiscal data.** In mid-2002, discussions were held on the possibility of subscribing to the publication the Special Data Dissemination Standard (SDDS). There are no published reports on fiscal outturns or financial assets of the municipalities.

C. Open Budget Preparation, Execution, and Reporting

25. **A statement of overall fiscal policy objectives of the annual budget is contained in the President's Report.**²¹ The budget documents do not contain an analysis of fiscal sustainability, in part because external and domestic debt is quite low. There is no discussion of the risks to the budget estimates in the event key variables underpinning the budget, such as international oil prices or the exchange rate of the Rial, should develop differently from that assumed.

26. **Two important fiscal rules are specified, either in the five-year Plan or in the annual budget.** These are: (1) a prohibition on government borrowing from the banking system, including from BMJII, to cover the budget deficit, and (2) a limit of \$25 billion on total net external obligations at end-2004, including contingent liabilities (Articles 69 and 85 of the TFYDP). However, additional government spending is possible by raising the amount of budgeted oil revenue or by running down the OSF's balance.²² Despite the first rule, in 2002/03, the government intends to borrow in foreign currency from two domestic banks. Besides these quantitative rules, there are also procedural fiscal rules, such as the one mentioned in paragraph 13 above.

27. **Budget preparation begins sufficiently early, but a coherent and comprehensive macroeconomic framework is not updated at the start of the process.** Annual budget preparation begins 8–9 months before the start of the new fiscal year, thereby allowing full discussion of the budget at both technical and political levels (Box 4). Targets in the annual budget are based largely on the TFYDP.²³ However, the TFYDP's projections are only updated mid-way through the Plan period, i.e., every 2½ years, not every year. Although the MPO has a macroeconomic model, it is not used for setting key budget aggregates; projections for non-oil revenues and expenses²⁴ are established after examination of the divergences of previous years' outcomes relative to TFYDP projections. New policies to be introduced in the annual budget are not clearly described in the budget circular; some new

²¹ See www.president.ir

²² For example, although the 2002/03 budget shows no BMJII financing of the non-oil deficit, part of the non-oil deficit was financed by a \$2.1 billion drawdown of the OSF.

²³ In essence, the TFYDP serves to provide the medium-term budget framework. It is however, not a rolling forward-looking plan, being constrained within a fixed five-year timeframe of 2000–2004.

²⁴ Following the adoption of the 2001 GFS standards, the term “expenses” is used for cash expenditures.

Box 4. The Budget Process

The MPO begins preparing the budget circular in July. After it is approved by the Economic Council, the circular is sent to central ministries, provincial agencies, SOEs, and state-owned banks in September.

The separate ceilings for current and development expenditures are negotiable, as they are not based on a regularly-updated macroeconomic framework. Ceilings are largely based on past allocations, adjusted for expected inflation and FYDPs' objectives. The budget is essentially a "bottom-up" process, with no firm "top-down" ceilings. The circular also contains instructions for preparing draft "notes" to the budget.

By early November, discussions at the technical level are completed. The MPO consolidates the draft budget for approval of the Economic Council and then Cabinet. The President submits the proposed budget to Parliament in early December, along with the President's Report on economic and budgetary developments.

Specialized parliamentary sub-committees and the Budget Committee scrutinize the budget estimates. Agreement on the detailed quantitative estimates is largely reached at this level. At Parliament's plenary session, the focus of the debates is on the "notes" to the budget.

Parliament approves the budget and the Guardian Council ratifies it before the beginning of the new fiscal year. The approved budget contains the "notes," some aggregate tables, detailed revenue and expenditure estimates; it is supplemented by three annexes: (1) all capital projects, (2) provincial budgets, and (3) the individual budgets of nearly 500 SOEs, the 10 state banks and the central bank's budget. Municipalities' budgets are excluded.

Implementing agencies are allowed some flexibility in reallocating sub-categories of the budget. The approved budget is based on expenditures classified by both economic and program classifications. For each of the 36 chapters, spending agencies may swap expenditures between both categories, within defined limits.

The responsibility for financial supervision of the budget is shared by the MEAF and the MPO. The MPO monitors budget implementation, especially physical and financial progress of capital expenditures. The MEAF is responsible for expenditure control and for preparing government accounts.

The MPO (including the Statistics Center under it) is charged with fiscal reporting. Although annual data is published by the MPO, higher frequency fiscal data emanates from the central bank (see paragraph 22).

The SAC audits the accounts of spending agencies, and reports to Parliament on implementation of the government budget. The AO audits the accounts of SOEs.

28. policies are introduced in the budget "notes," which are negotiated at the various stages of the budget process.

Since the macroeconomic framework is not updated annually, it is unclear how projected oil revenues will be used over the medium term. The annual budget document does not discuss how the projections of oil revenue (in Rials) are derived from the assumptions concerning the dollar export price, the exchange rate, the volume of oil exported by the National Iranian Oil Company (NIOC), the amount of oil revenues retained for extrabudgetary spending and for the NIOC to cover the costs of exporting. Extrabudgetary

spending from oil revenue is of two types: first, that retained for the repayment of buybacks and external debt, as well as other special expenditure authorizations; and second, the transfers to the OSF. The budget document does not provide estimates for these two types of extrabudgetary spending. Parliament is therefore unable to debate off-budget activities whose size is likely to be quite significant. Nor is Parliament provided with a table showing the government's lending activities for policy purposes, particularly those using OSF resources.²⁵ Finally, when the annual budget is discussed, the projected amount of oil revenues in dollars (as contained in the TFYDP) is not updated for years beyond the next fiscal year.

29. The new budget classification adopted in 2002/03 facilitates analysis, is broadly consistent with international standards, and allows budget programs to be specified.

Beginning with the 2002/03 budget, functional, program, and economic classifications of central government expenditures are shown. The specification of budget programs for selected ministries, inclusive of output indicators, began in the 2002/03 budget; it is planned to expand the programmatic approach to other ministries and to improve the program costings.

30. The overall balance of central government is the key target for fiscal policy, although the non-oil balance is also presented. The budget document available publicly does not include an analytical table showing the various components of the overall balance. Privatization receipts, which are expected to become increasingly important, are identified in the budget. The overall public sector balance is not used as a key policy variable.

31. The accounting system is cash based, hence is not able to generate information on liabilities such as tax and expenditure arrears. Furthermore, monthly spending data on a payments (checks-issued) basis, although sent by spending ministries to the Treasury, are not consolidated. Noncash domestic transactions, such as the offsetting of government arrears to the SSO by transfers of government shares in public enterprises to the SSO, do not enter government accounts.²⁶ Concerning foreign transactions, only loans from the main multilateral lenders are recorded in government accounts; other foreign financing, such as buy-backs or commercial financing by SOEs, has not been recorded until recently.²⁷

32. Procurement regulations are in place, but they are not uniform across ministries.

The general provisions for government procurement, including for the composition of tender boards, bidding, and awarding of tenders, are laid out in Articles 79 to 90 of the Government Accounting Law 1987. There are three types of bidding: open international competitive bidding, limited international bidding, and domestic bidding. Below a certain threshold, the need for tendering is waived. All contracts subject to international bidding require the approval of the Economic Council. For domestic bidding, each government agency has its own tendering procedures and thresholds vary, thereby adding complexity to the procurement

²⁵ GFS recommends identifying "net lending for policy purposes" (see Box 4.1 of the 2002 GFS Manual).

²⁶ The netting of government arrears to the SSO were reflected, however, in the 2002/03 budget.

²⁷ For the OSF, in 2002/03, the BMJII began keeping records of buybacks and reporting these to the MEAF and the MPO.

process. Moreover, enterprises owned by state banks, the SSO, or *bonyads* are not subject to the same procurement regulations as government agencies. The existing procurement regulations are in the process of being revised.

33. Internal control procedures are enforced by a network of Treasury financial controllers. For each central government spending unit specified in the annual budget²⁸, the Financial Control and Supervision Division of the Treasury Department (of MEAF) assigns a financial controller. In all of the larger ministries and SUs, including those in the 28 provinces, at least one financial controller is appointed. There are over 800 financial controllers nationwide who are responsible for: internal control (compliance with treasury financial instructions); co-signing checks (SUs' accountants also sign); keeping accounts of the SUs' financial transactions; and providing monthly reports to both the head of the SUs and to the Treasury. Internal audit arrangements have not been instituted in spending ministries. For nongovernmental public institutions, including municipalities and *bonyads*, the Treasury exercises internal control over government transfers to these entities.

34. The national tax and customs administrations are not given legal protection from political interference. The NTO is responsible for the collection of all taxes except trade taxes and excises—the CA is responsible for collecting these revenues. Both organizations are under the auspices of the MEAF. Under the TFYDP (Article 59), the MEAF is still responsible for defining the NTO's organizational structure. The CA has a number of publications that reports on its activities.

35. Monthly revenue and expenditure reports are neither prepared nor published. However, the Treasury can provide to Parliament, the MPO, and the BMJII tailor-made reports, should these agencies demand them. "Expenditures" compiled by the Treasury represent transfers of funds from the Treasury bank account into those of the spending agencies and are not cash payments made by the latter.

36. No mid-year report describing budget implementation is provided to Parliament. Nor does the Legislature receive updated forecasts of macroeconomic indicators, main budget aggregates, fiscal balances; and reasons for deviation, if any, from the approved budget estimates. The Parliament can, however, request information from SUs throughout the year. Some notes of budget laws oblige SUs to present quarterly budget execution data to the Parliament.

37. Annual accounts of the central government, compiled by the MEAF, are presented to Parliament, pending certification by the SAC, after a lag of approximately one year. Final audited accounts are presented after a further lag of 6–12 months. The final accounts cover transfers to SOEs, extrabudgetary funds, and nongovernment public institutions but not a consolidated picture of their fiscal operations. The time lag in the finalization of annual

²⁸ In the 2002/03 budget, 516 SUs were specified, a considerable reduction from the 800 or so in prior years.

accounts is partly attributable to the extended complementary period for closing accounts, as discussed in the following section.

D. Assurances of Integrity

38. The annual government budget is formulated in close conformity with the FYDPs. A supplementary budget is presented to Parliament towards the end of the fiscal year to realign the approved estimates with outturns.

39. The government accounts are maintained on a modified cash basis, although no formal statement on accounting policy is included in the budget documents or in the annual accounts. The Treasury is responsible for setting accounting standards. The annual financial statements generated at the Treasury comprise statements of receipts and payments against budget appropriations and cash flow statements. Modifications to the accounting policy can be made by the MEAF in consultation with the SAC.

40. There is a very long complementary period for closing accounts. Legal sanction is available for keeping the annual accounts open after the end of the fiscal year for complementary periods of 15 days for current expenditures, four months for capital expenditures, and one year for some spending agencies such as the universities and the Ministry of Defense. The prolonged complementary periods make in-year tracking of expenditures against the budget appropriations difficult.

41. The Treasury does not prepare in-year reports on total cash expenditures. The Treasury allocates budgetary resources from its main account at the BMJII to an estimated 2,500 bank accounts maintained by the SUs in commercial banks.²⁹ The SUs administer and prepare statements for payments made from their accounts. Monthly statements are submitted to the SAC for audit and to the Treasury for record, with a lag of up to one month. The accounts are, however, not consolidated at the Treasury, except when compiling the annual accounts at the end of the fiscal year.

42. The authorities plan to introduce selected features of accrual accounting in phases during the remaining period of the TFYDP 2000-2004. For the present, the GFS 2001 classification structure has been employed for presentation of the budget estimates and budget execution data without effecting any change in the existing basis of accounts.

43. Well-defined processes exist for ensuring, to the extent that payment and accounting systems permit, internal consistency of fiscal data. By restricting allocation of funds to the SUs within available appropriations, the Treasury ensures that actual expenditures remain within the amounts authorized by the Parliament. Reconciliation of individual accounts of fiscal operations with bank accounts is apparently undertaken monthly by local SUs and cross-checked, if necessary, at the Treasury. However, at the aggregate level, reconciliation

²⁹ The SUs typically maintain between 1-10 separate bank accounts, each dedicated to major line items in the budget. For the approximately 800 SUs, an average of 3-4 bank accounts have been estimated.

of fiscal and monetary data presents special difficulties. This is for various reasons, including the way remitted data are aggregated at successive stages, the account books remaining open for extended periods (see paragraph 39 above), and the inconsistencies between the definitions of “government” followed by the BMJII and the Treasury.³⁰ Audit by the SAC of final accounts is carried out effectively, but after a significant lag extending up to one year. The budget institutions also send monthly accounts to the SAC.

44. The audit framework for the public sector consists of the AO under the aegis of the MEAF, and the SAC operating under the direct supervision of Parliament. Together, these two institutions cover the entire public sector.

45. The AO was established by an Act of Parliament in 1987 and has operational independence from the MEAF in performing its functions. It is responsible for statutory audit of all non-financial and financial SOEs, capital projects under National Development Plans, as well as nongovernment public institutions including several *bonyads*.³¹ It is responsible for setting national accounting and auditing standards for the nongovernment sector, including SOEs. The national standards closely correspond to the International Accounting Standards (IAS) and the International Standards on Auditing (ISA). It renders audit opinion under four broad types: unqualified, qualified, adverse, and disclaimer. For 2000/01 accounts, 69.4 percent institutions received qualified opinions and 19.3 received adverse or disclaimer opinions. The AO submits its audit opinion to the Board of the audited institution. The SAC at its discretion may requisition any audit report completed by the AO for review and opinion.

46. The SAC derives its authority from the Supreme Audit Court Act, is independent of the Executive and reports to Parliament. Its jurisdiction extends to “all the ministries, government institutions and companies as well as other organizations that draw, in anyway, on the general budget.”³² The SAC enjoys independence in financial and administrative affairs. Its budget, after the approval of the Commission on SAC of the Parliament, is included in the government budget. The President of the SAC can be removed from office only by Parliament. The Judiciary Boards of the SAC are appointed with the approval of the Commission on SAC, and the Public Prosecutor of the SAC is appointed by MPs through a majority vote. The Judiciary Boards adjudicate financial irregularities and have powers to punish public officials found guilty. Cases requiring penal action are forwarded to legal authorities. The SAC submits a consolidated annual report on its audit of the public sector to Parliament where it is discussed and dealt with as appropriate. Parliament may, at its discretion, scrutinize financial reports of any institution referred to in the SAC report.

³⁰ The monetary data published by the BMJII half-yearly bulletin presents claims on and deposits of the public sector differentiating between “Government,” which is confined to the central government, and “Public Corporations and Agencies” which includes municipalities.

³¹ During the year 2000-2001, the AO audited 1,233 SOEs (including subsidiary companies), 498 enterprises controlled by *bonyads*, 283 enterprises controlled by state-owned banks, and 57 other institutions.

³² Article 55 of the Constitution.

47. Macroeconomic forecasts and underlying assumptions are not available for assessment by independent experts. Therefore, it is not possible to assess the reasonableness of the budget estimates. Non-oil revenue projections seem to have been consistently overstated.³³ Three major reasons have contributed to this: first, estimates for the year ahead are based on FYDP projections rather than the estimated outturn for the current year; second, the quantitative impact of changes in tax exemptions is not estimated; and third, there is an implicit assumption that new administrative measures will be taken in order to reach the planned revenue target.

48. The SCI reports to the MPO but has independence in technical matters. Its charter of responsibilities includes preparation of fiscal data. However, in practice, it does not verify the quality of these data.

III. IMF STAFF COMMENTARY

49. Following the enactment of the TFYDP, the Islamic Republic of Iran has made commendable progress in enhancing transparency in fiscal operations of the public sector. QFAs associated with the multiple exchange rates have been eliminated, other QFAs are increasingly being recognized as explicit subsidies in the government budget, and the GFSM2001-based classification structures for budget estimates and reports have been adopted. The audit framework for the public sector is anchored on a robust legal framework, on independence of administrative and financial affairs, and on international auditing standards. While progress has been slow in generating timely reports on government fiscal operations, improvements are visible in their dissemination in the media and on government websites.

50. There is, however, room for improvement in the following areas, listed in order of priority:

- Coverage of the general government and the public sector in conformity with the GFS, and the administrative and financial relationship between the government, SOEs and other nongovernment public institutions;
- Accounting processes and the quality of fiscal information; and
- Budget management, participation of Parliament and civil society in the formulation of fiscal policy, and dissemination of information on fiscal operations of the government.

51. The government's involvement in the economy should be transparent and fully reflected in its fiscal operations. At present, the government controls directly and indirectly the administrative and financial activities of public sector financial and non-financial

³³ For instance, for 2002/03, IMF staff estimated that the budgeted non-oil revenue could be overstated by more than 2 percent of GDP.

corporations, including the BMJII. The central government budget incorporates the budget of each of these entities and lays down targets for certain quasi-fiscal operations. On the other hand, the budget excludes the financial operations of “nongovernment public institutions” such as EBFs, the SSO, *bonyads* in the public sector, and municipalities. The following paragraphs make recommendations for enhancing the transparency of the fiscal operations of these institutions.

52. The institutional relationship between fiscal and monetary operations of the BMJII, and its agency roles on behalf of the government should be clearly defined. This is a requirement under the monetary and financial transparency code.³⁴ The public sector banks and non-financial public corporations continue to undertake fiscal and quasi-fiscal operations as mandated in the TFYDP and the “notes” in the annual budget. International best practices advocate an arm’s length relationship between the government as the owner and the SOEs to enable them to operate on a commercial basis, with the full cost of their QFAs covered by the budget. Granting the BMJII full legal autonomy from the executive arm of the government is a desirable goal over the medium-term. Parliament should dispense with the requirement of approval of the annual budgets of SOEs, but demand regular reports on their business plans, actual operations and annual financial statements together with the audit opinion.

53. All extrabudgetary activity should be systematically tracked by the MEAF or the MPO and reported to Parliament. To meet the requirement of fiscal transparency, the operations of all EBFs and other off-budget spending should be underpinned by an explicit legal framework. In particular, off-budget spending from oil revenues that is currently nontransparently excluded from both the budget and the OSF should be incorporated into the central government budget. Given the size of its lending operations, the OSF should be presented as part of the government budget. Besides approving the budget of the OSF, Parliament should be provided with the OSF’s audited accounts in a timely fashion. This would enable Parliament to ensure that the lending activities of the OSF are consistent with both medium term fiscal sustainability and with sectoral allocation priorities, as defined in the TFYDP. More generally, all EBFs should be identified, and their budgets and audited annual accounts should be presented to Parliament along with the general budget and then published.

54. The transparency and accountability of operations of all nongovernment public institutions including the SSO and *bonyads* in the public sector require substantial improvement. While fragmented information on operations of some of the entities controlled by them is available, a comprehensive report on the totality of their audited financial operations should be made available to Parliament and published. For *bonyads* that perform both social and commercial activities, transparency would be enhanced if separate institutional and accounting arrangements were established for their governmental and nongovernmental functions.

³⁴ Sections 1.2 and 1.3 of the IMF Monetary and Financial Transparency Code.

55. The government budget should include information on budgets of municipalities and a consolidated report of their operations. This would bring the general government reports in conformity with international norms. A consolidated report on municipal operations should be included in reports generated by the Treasury and BMJII and presented to Parliament.

56. The budget execution and reporting system requires significant improvement, so that it can generate timely fiscal data of acceptable quality. Important steps in this direction are outlined below.

- **A comprehensive review of government banking arrangements is needed, with a view to reducing significantly the number of such accounts,** and to enabling daily reports on the end-of-day cash balances to the Treasury for installing cash planning discipline. The present banking arrangements for government payments result in the fragmentation of cash resources and generate idle cash balances in numerous bank accounts of spending units.
- **The prevailing practice of unduly long complementary periods for budget expenditure after the close of fiscal year should be reviewed.** Permitting complementary periods as long as four months to one-year delays the finalization of annual government accounts and compromises the integrity of fiscal aggregates. The annual government accounts should be finally closed within four weeks of the end of the fiscal year.
- **Reports on monthly receipts and actual expenditures of the SUs should be received at the Treasury within 1-2 weeks and consolidated, and monthly fiscal reports of acceptable data quality should be prepared within 4 weeks of month end.** Once available, consolidated monthly fiscal reports should be disseminated to the parliamentary Budget Committee, the MPO, the BMJII, and other concerned agencies, and should also be published for wider coverage.
- **A comprehensive mid-year report on budget implementation should be presented to Parliament and published.** The report should, among other matters, provide updated forecasts of budget revenue expenditure and financing items with comparative figures for previous years of the TFYDP, a forecast on the budget outcome for the fiscal year, and should identify factors responsible for the deviations from original budget estimates.

57. Annual accounts of the government fiscal operations, together with the audit opinion of the SAC, should be formally presented to Parliament for approval within one year of the end of the fiscal year. This will provide Parliament with the opportunity to review the progress in the implementation of the TFYDP, and address emerging fiscal scenario for corrective action.

58. The existing cash-based accounting system should be upgraded to enable recording of expenditures at the pre-payment stage. Recording of and reporting on expenditure commitments by the SUs will permit effective tracking of payment arrears and enable the Treasury to provide for cash resources to extinguish pending claims of the suppliers of goods and services to the government. This step, together with the others recommended above, should enhance expenditure control and the integrity of fiscal data.

59. A system of internal audit of fiscal operations should be installed in each spending unit to supplement the existing internal control arrangements overseen by the financial controllers. The objective of ex post internal audit is to provide to the head of the SUs a report on the effectiveness of the internal control regime, and to permit timely corrective action to address instances of irregularities and misuse or mismanagement of public funds. The internal audit procedures should be developed by the Treasury and should be open to review by the SAC and others. Reports on internal audit should be made available to the SAC.

60. The government budget formulation process has been substantially strengthened since the enactment of the TFYDP 2000-2004. To further strengthen the budget framework, the following steps are suggested:

- **The macroeconomic and budget framework should be comprehensively updated each year at the early stage of the budget cycle to generate reliable estimates of fiscal aggregates.** This would enable the Economic Council to formulate sustainable fiscal policy and determine expenditure ceilings for the agencies. Publication of the macroeconomic updates and encouraging their objective appraisal by academic institutions would allow the budget to be underpinned by a transparent and reliable macroeconomic framework.
- **Annually-updated medium term projections should be presented for the non-oil fiscal balance, oil revenues, and OSF expenditures, with a clear specification of the underlying assumptions,** especially the price and volume assumptions underlying projected oil revenues—those included in the central government budget and the revenues expected to be transferred to the OSF. There is also a need to discuss the principal risks associated with the budget projections, especially the vulnerability of revenue projections, not only for oil (due to changes in international oil prices and exchange rates), but also for non-oil revenues (due to changes in tax rates, exemptions, improvements in tax and customs administration, etc.).
- **For a rational formulation of the budget, the Economic Council should prioritize sectoral programs in accordance with the medium term fiscal plans, determine annual expenditure ceilings for each budget manager, and communicate this to the agencies through the budget circular.** Lack of defined ceilings, as at present, encourages budget managers to inflate their demands without due consideration of the overall resource constraints and government's priorities.

- **The budget document should contain sufficient information to enable the parliamentary Budget Committee to make informed decisions on the budget.** Specifically, the Committee should be provided with narrative information on the progress on implementing important programs, and the objectives of new fiscal policy initiatives. Among other information, the budget documents should provide information on contingent liabilities, tax expenditures, quasi-fiscal operations, the composition of debt and financial assets.