


## EVOLUTION AND MODIFICATION OF FOREIGN FINANCE PROVIDING IN IRAN LEGAL SYSTEM

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### Abstract:

Foreign finance providing is one of the important points and a requisite for economic activities in all developing countries. Specifically, this is the case in Iran, where it is also a core issue.

At national level, there are legal sources for foreign investment in Constitutional Laws as well as some ordinary laws and regulations in concrete details. This paper relates to the procedure to modify these laws and regulations inside the organizations.

Conclusions indicate that it had been better issuing and making the regulations about providing foreign finance and omitting interrupting rules (red-tape).

**Keywords:** *providing foreign finance laws; evolution of foreign investment regulations agenda; developing countries; Iran*

## EVOLUCIÓN Y MODIFICACIÓN DE LA PROVISIÓN DE FINANCIACIÓN EXTERNA EN EL SISTEMA LEGAL DE IRÁN

### Resumen:

La provisión de financiación externa es uno de los puntos importantes y un requisito para las actividades económicas en todos los países en desarrollo. Específicamente, éste es el caso de Irán, donde también es una cuestión fundamental.

A nivel nacional, hay fuentes jurídicas para la inversión extranjera en las Leyes Constitucionales, así como algunas leyes ordinarias y reglamentos sobre detalles concretos. Este artículo se refiere al procedimiento para modificar dichas leyes y reglamentos dentro de las organizaciones.

Las conclusiones indican que habría sido mejor emitir y elaborar regulaciones sobre la provisión de financiación externa y omitir las reglas interruptoras (burocracia).

**Palabras clave:** *leyes de provisión de financiación externa; evolución de la agenda de reglamentos de financiación externa; países en desarrollo; Irán*

## 1. Introduction

In different periods, financial laws in Iranian legal system have performed much more as interfering regulations than as profitable laws for foreign investment, up to the point that, at last, it resulted in a lack of attention to foreign investment. Five economic, cultural and social agendas have been planned since 1989, and subsequent results have given rise to a 5% in terms of annual economic growth.

However, even when this percentage could be considered as positive, it should have been higher, namely 8%, according to the agendas (art 234, Fifth Five Year Development Plan of the Islamic Republic of Iran 2011-2015).

Such objectives were approved due to the increasing economic growth figures, an increase in social welfare and a decrease in jobless rate. Considering a twenty-year landscape agenda and due to the act 44 of Constitutional Laws, this should increase public cooperation. Next, and aiming to provide a suitable base, an economic evolution plan was declared.

The five Development Agendas of the Islamic Republic of Iran, the general policies in these Agendas, the Iranian Landscape Document 2025 and recent budgetary regulations point to a specific attention to foreign finance providing.

The financial resources needed for development and construction purposes were usually provided via both local and foreign sources. Foreign finances were required due to the limitations in local resources for constructive projects, such as barrier construction, setting up refineries, or building roads, airports and railways. In this sense, there were different ways to provide it, including direct and indirect investment. At any case, foreign investment has a high importance in making and continuing economic development projects in developing countries.

## 2. On the concept of foreign finance providing

Developing countries use to show less economic growth rates when compared to developed ones. One of the main causes of this situation is the lack of suitable finances and the lack of investment, then becoming really important issues in country development agendas.

To be precise, investment has a particular position in any country. Nevertheless, we should keep in mind that in this concern, foreign investment is important though sometimes in developing countries foreign incomes are not coordinated with their expenses and they need additional foreign finance for funding their constructive projects.

Foreign finances can be provided by three ways: i) individual direct investment; ii) individual indirect investment; and iii) as loans from international financial and funding institutes or wealthy countries. Each one of these three methods has advantages and disadvantages for the country applying for foreign finance. In the one or the another way, we could say that it can have significant effects on the economy as a whole and its policy-makers. In case we could determine relative economic advantages in one of the methods for foreign finance providing, this method would be selected as the most proper way of investing in the country.

Regarding Iran, the conditions imposed after the war period and the beginning of the reconstruction era assigned to these issues even a higher importance. The inflation activity in the years of 1985-1988, together with a stable economic growth around 7.8% and the increase of 28.9% in costs of goods and services in 1988 determined that such matters as decrease of oil cost, increase of war costs and state budget shortage –as well as in companies– influenced in problems as lack of economic planning and lack of economic agendas via specifying the individual parts' tasks, then leading to the decrease of the economic growth in the country, which meant not having a proper economic growth, a situation continued in the following years (art 29, First Five Year Development Plan of the Islamic Republic of Iran 1990-1995).

In such economic instability context, different orders were issued by the Central Bank and the Ministry of Economic Affairs. The fluctuation of exchange rates made importing profitable instead of producing in the country, due to the cheap foreign currency change and the powerful relations with the external world. Then, all together with the inflation at world level, caused the weakness of the state in absorbing foreign finances which were mostly shaped by loans and maturity in short periods.

Anyway, the blanked capacity was fulfilled by the end of 1992 and a weak individual operation activity was registered. The individual rate was 8'1% during the years 1989-1993 and the local one was almost 14'7% (while 18'7% and 23'2% were the goals included in the Development Plan). Additionally, the country should also face the difficulty of no rejection of oil stocks exchange gained from selling oil.

Regarding the economic growth, the Second Development Agenda included action lines as:

1. Paying more attention to organizing different bazaars.
2. Providing permanent growth and development.
3. Providing jobs to increase individuals' income.
4. Increasing the tax incomes to reform the budget construction.
5. Developing the industrial rate and improving the quality of goods, etc. which again was declared as a result of applying foreign finance (art 29, Second Five Year Development Plan of the Islamic Republic of Iran 1996-2000).

The Iranian Landscape Document 2025 designed high level programs regarding lines 4 and 6 aiming the goal of reaching a higher position of Iran in the South-West Asian region. All the above points insisted on the requisite of setting up an economical system in the country.

From a methodological view, this research had faced problems as the lack of statistical sources and the undefined information, namely regarding the following issues:

1. The contrasts between figures regarding foreign loans in local publications (statistics published by the Central Bank) and international annual directories.
2. The pause in foreign payments and foreign investments due to the country regulations and the international sanctions against Iran.

### **3. Bases and development of the process for legal foreign finance provision in Iran**

In this paper we will consider the concepts on finance provision accordingly to the World Bank methodology. So, *Foreign Direct Investment* (FDI) "occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments. In most instances, both the investor and the asset it manages abroad are business firms" (Blackhurst and Otten 1996).

In FDI, the foreign investor controls the asset in the host country by presentation at location and admitting responsibilities. FDI aims the cooperation of one or several foreign companies in a country where they have legal rights for investing. FDI involves possibilities as possession or buying, making a company substitution, cooperative investment, cooperation at producing, cooperation at profit and partly cooperation (WTO 1997).

The difference between FDI and *foreign indirect investment* is that the latter one occurs when the foreign investor has not got any share of fund and/or cooperative investment, then being situated on the level of foreign indirect investment subject. It does not have supervision or legal responsibility, and just receives profit depending on its share.

#### *3.1. Iranian Constitutional Laws on foreign investment*

The most general way of supporting foreign investment is by regulating it in the Constitutional Laws. It has a far importance although the Constitutional Laws just analyze the general points and neglect details. The complex process usually linked to modify Constitutional Laws provide a important warranty to support foreign investment.

In case of Iran, the Constitutional Laws<sup>1</sup> include different principles pointing directly and indirectly to foreign investment, namely arts 81 and 139.

<sup>1</sup> The Iranian Constitution was adopted on 24<sup>th</sup> October 1979 and amended on 28th July 1989. The source text (in Persian) can be retrieved from the Ministry of Interior site at <http://www.moi.ir/>. A good unofficial English version based on a translation

To be precise, the art. 81 of Constitutional Laws states that “the granting of concessions to foreigners or the formation of companies or institutions dealing with commerce, industry, agriculture, service, or mineral extraction, is absolutely forbidden”. A number of authors and experts refer to this act as the main point in opposition of foreign investment in Iran.

Regarding this issue, the interpretation by the Guardian Council of the Constitution is as follows:

1. Companies operating on financial participation are exceptional and they have the permission for their activity.
2. Foreign cooperation can be conducted at personal participation on the condition that this participation cannot exceed 49% of shares.
3. The registration of foreign companies allow financial activities without needing a governmental contract for setting up banks and insurance companies. The all discussion is about whether the meaning of interest means monopoly, informed knowledge on the activity or anything else. The official contracts of the Government usually refer to contract convention or prerogative convention.

On the basis of the first contract, the Government transfers a public service to a juridical or natural person by public budget, which runs it during a defined time period accordingly to defined conditions and taking profit to its own, whereas it gives some amount or pays a share to the Administration. It was declared on interpretation of this principle the absolute character of the prohibition of “giving the property”, i.e. setting up companies in the industrial, financial and agricultural sectors via transferring the property is absolutely prohibited. Following some experts’ view, this implies a complete prohibition of foreign companies registration, while other ones think that the principle deals with prohibition on defined points. The most logical interpretation is that the prohibition should imply a defined condition for foreign property, as when a foreign company share is 49% or less the score does not shape (Imam 1994).

Regarding the art. 139 of Constitutional Laws, it states that “the settlement of claims relating to public and state property or the referral thereof to arbitration is in every case dependent on the approval of the Council of Ministers, and the Assembly must be informed of these matters. In cases where one party to the dispute is a foreigner, as well as in important cases that are purely domestic, the approval of the Assembly must also be obtained. Law will specify the important cases intended here”.

### *3.2. Iranian ordinary laws on foreign investment*

In recent years foreign investment has not been restricted, but it has been spreading in most countries, specifically in case of developing countries. As a consequence, there have been promulgated laws dealing with issues such as entering prosperity, interest transfer, damages compensation, procedures to solve problems, or customs exemptions, all of them more or less closely related to investment. Following, an overview on main ordinary laws in Iran including legal requisites to foreign investment is presented.

The first law on this concern was the Law of October 29<sup>th</sup>, 1955 on Attraction and Protection of Foreign Capitals aiming the absorption of foreign investment. This legal text refers not only to regulation procedures, but it also includes several articles devoted to introductory concepts and definitions, and its procedural bylaw was approved on 1956. The law was abolished after nearly 48 years in force, when the Law on Encouragement and Protection of Foreign Investment was approved.

The Law on the Administration of Free-Trade Industrial Zones was approved on September 12<sup>th</sup>, 1993. Its art. 8 states that “the Authority and its affiliated companies are permitted to conclude the necessary contracts with natural or legal persons, whether foreign or domestic, and to participate with natural or foreign investors for the implementation of development and productive projects, with the observance of the stipulations of the Constitution. Disputes and claims arising out of the concluded contracts, shall be examined and settled on accordance with the mutual agreements and the contractual commitments of both parties concerned”. So this principle admits foreign technical and economic assistance to natural or legal persons as admitted in number 23 T 334332 on 15<sup>th</sup> June 1994 by the Council of Ministers, even when restricted to free-economic (trade) zones. A new law on 2<sup>nd</sup> March 2009 clarified how to run the free economic zones in comparison admission 1993 in which it was facilitated to obey an easier regulation.

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provided by the Iranian Embassy in London is available from the University of Bern, as part of the Project “International Constitutional Law” (<http://www.servat.unibe.ch/icl/>).

Later on, the Law of February 8<sup>th</sup>, 2001 on Encouragement and Protection of Foreign Investment<sup>2</sup> made possible investing in all economic Iranian sectors. In fact, and according to this legal text, there is no field but weapons restricted to the activity of foreign investors. The Law also provides an acceptable security warranties in front of financial risks, even when the term “financial risks” is not specifically mentioned. Issues as interest transference are considered and the legal text also provides rights to all investors via facilitating the needed stock for their transportation. It is also mentioned that there is no limitation about the amount of by back interest, and investors’ rights are recognized regarding Administration decisions or when running a project which suffers interruptions or delays.

In this sense, following issues are important when paying attention to the absorption of foreign funds:

1. Regarding the art. 45 of the Law on Attraction and Protection of Foreign Capitals, it is clarified that the activity of foreign investors is allowed due to the document stating the amount entered, then allowing the possibility of harvesting benefits and sending them out of Iran.
2. According to the art. 5 of the mentioned law, transferring and maintaining in the country the main capital and its resources is possible by considering the rules of the Agreement on June 1994 about international funding. However, the owner of the capital has to put at least a 10% of the prior capital as provision in order to face potential commitments in Iran.
3. According to the art. 3 of the mentioned law, the question of depositing property was not considered, and the possibility of cancelation is possible. Hence, the arrival of capital to the country is not warranted.
4. Coming back of transferring funds would be based on a daily rate.
5. Also due to the mentioned art. 3, the establishment of foreign banks is not allowed, even if there is legal interest on such local investor admission.

### *3.3. Five Year Development Plans in Iran*

Up to the moment, five Five Year Plans on Economic, Social and Cultural Development have been approved and implemented in Iran. The issue on foreign finance providing attracted attention in the second one of these development agendas, but its treatment in the fourth one was more precise.

Specifically, the complex art. 19 of the First Five Year Development Plan of the Islamic Republic of Iran 1990-1995 allowed the State setting up business and industrial zones in three regions of the country. Due to the art. 20, Iran customs and the organization of ports and shipping were designed to setting up the concrete region to be supported. After an overview on the text of the First Plan, it is possible to see that there is no mention to foreign investment, but just punctual references to concepts as “credits” or “mutual selling” in the business field, with no foreign investment –as mentioned– to absorb them.

Foreign finance providing was considered in the Second Five Year Development Plan of the Islamic Republic of Iran 1996-2000 (line H of sub-chapter 22 of the rule) when referring to the way the free economic-industrial zones were running after a long period of 15 years. The related issues were unattended but in action because of different reasons, such as stock fluctuations, different and opposite interpretations of arts. 44 and 81 of Constitutional Laws, or regulations concerning foreign investment. At any case, a weak operational activity was observed regarding the absorption of foreign funds in the country.

The Third Five Year Development Plan of the Islamic Republic of Iran 2001-2005 continued the trend of paying attention to the issues associated to the absorption of foreign funds by allowing the State (line B of art. 85) accepting them. During this period, the State decisions did not succeed on attracting foreign investments. Everything depending on investments, Iran had the record of facilities to absorb foreign capitals with 57 rates, occupying the 130<sup>th</sup> place at world level (UNCTAD 2006).

The Fourth Five Year Development Plan of the Islamic Republic of Iran 2006-2010 can be considered as an innovation in foreign finance providing procedures and the laws and regulations concerning to them. The line B of the art. 13 of the legal text and the chart 27 led to prove the efficacy in the absorption of foreign finances of the art. 84 in the Islamic Council. This way this issue was mentioned or predicted in the advanced budget plans by supplying foreign finance.

<sup>2</sup> Also known as the Foreign Investment Promotion and Protection Act (FIPPA).

Specifically, this line B of the art. 13 indicates concrete State duties, namely:

1. It should classify the paying back of debts as short term or long term. Without considering the Fourth Agenda scenario, at the end they should not exceed in 30% the State incomes, long term facilities being the priority.
2. It should regulate the foreign debts existing at the end of the Fourth Development Plan due to country debts and commitments derived from the contracts to encourage foreign investments admitted on 12<sup>th</sup> September 2001 (the extra payment of costs of country debts and commitments during country repertoires of the Central Bank of the Islamic Republic of Iran) which, at the last year of the Plan, should not exceed the amount of US\$ 30 billion.
3. Application to financial banks is justifiable with State warranties and considering the above mentioned facilities to finance providing for non-governmental investments from international sources.

These regulations led to the admission of the 2005 Budget by the Islamic Council, which by the end of 2004 admitted that the finance supplies were accepted on the condition that they were not surrounded with interest loans. At the same time, it was considered paying attention to the possibility of turning foreign finance into an important issue in regulations.

Thus in 2005 applying foreign finances was approved by the Islamic Council and, at last, it was admitted by the Legislative Council. due to the mentioned regulation, during the Economic, Social and Cultural Development Agenda of the Islamic Republic of Iran (line B of art. 13) the State was permitted to apply foreign finances by legal permissions. The limit on applying facilities in 2005 and each one of the years of the Fourth Development Agenda was clarified at line B of chart 7.

In this sense, it is interesting that the legal text indulged to this rule the cancelled line N of the Budgetary Agenda for 2005, as being apparently allowable the application of interests to loans from foreign sources. This means that, although it was declared the possibility of applying foreign finances on the condition of no interests by the Islamic Council (2<sup>nd</sup> September 2005) and the General Council (11<sup>th</sup> October 2005), the mandate of the General Council is cancelled.

In general terms, the policies of the Fourth Development Agenda (arts. 29, 45 and 46) insisted on building a confidence climate for absorbing foreign investment and finances.

More recently, the Fifth Five Year Development Plan of the Islamic Republic of Iran 2011-2015, approved on 2<sup>nd</sup> November 2010, introduced further clarification on the application of foreign finance. In this sense, it is important to know that obeying the Islamic regulation norms should refer to the General Supreme Council, which admitted in 2005 the possibility of applying foreign loans on the condition of no interest.

In the art. 82 of the Fifth Development Plan it was stated that:

- a) Applying foreign finances during the Agenda is acceptable in the frame of budgetary regulation. The remaining facilities from foreign finances and facilities concerning the Third and Fourth Agendas (by obeying the Islamic regulation and under supervision of the General Council) remain during the Fifth Agenda.
- b) Executive systems for providing finances are allowed, considering the fact of no comeback of commitments by the State that the Central Bank and local banks were going to apply after the Economic Council (individual banks are exempt).
- c) Finance providing on financial and professional banks from foreign investment companies and international sources is allowed. However, the amount of the commitments and stock debts in any bank should be approved by the Fund Council. Moreover, the Fund and Money council should approve the application of b) in terms of facilities. Now the position of the Fund Council and the Economy Council should be compared.
- d) It is necessary considering the subjects included in points a), b) and c).
- e) It is also necessary to take into consideration the content of the reformative Law of April 2<sup>nd</sup>, 2011, regarding foreign dealings for more than US\$ one million.

### 3.4. Legal proves at annual budgetary regulations

The Budget Act 2010 (approved on 3<sup>rd</sup> February 2009) referring to the art. 3 of the 2009 Budget, stated that the remaining property admitted facilities regarding mutual sealing and foreign finances from the application of the Law of August 12<sup>th</sup>, 2005, on Foreign Facilities, and currency commitments in the previous year budget remained in 2010.

Then, the Budget Act 2011 determined in US\$ 30 billion the quantity in the Budget Act 2010 from systems of finance application.

In the art. 12 of the Budget Act 2012 the application of such amount of US\$ 30 billion was admitted via the Economic Council and according to the art. 82 of the Fifth Development Agenda.

The Budget Act 2013 was accompanied by a revision approved on 20<sup>th</sup> October 2013. According to its art. 20 and sub-section 4, it will be possible providing the State US\$ 30 billion via national repertoire. In this sense, it was declared the possibility of applying national repertoire finance at the provision by 20<sup>th</sup> December 2013.

In the Budget Act 2014, according to the sub-section 4, and due to the art. 82 of the Fifth Development Agenda, US\$ 35 billion were donated to individual and executive institutions to be absorbed by cooperative and individual parties. The mentioned issue on different parties in the art. 44 (local, individual, cooperative) indicates that they can apply to State finance from 2014 Budget, a possibility that was not mentioned in the previous budgetary regulations and which can mean an evolution in absorbing more foreign capitals.

## 4. Conclusion

The different Development Agendas, and specifically the Fifth Five Year Development Plan of the Islamic Republic of Iran 2011-2015 emphasizes the importance and necessity of investment when aiming to reach the goal rate of 8% growth. In this sense, an analysis of the reasons of not attaining a stable economic growth point to the need of increasing both factors related to staff and investment.

However, the lack of return to foreign investment as well as a no ever clear regulation have led to a stop in terms of investment flows. Hence, under the assumption that laws are to be obeyed, there should be a general encouragement aiming foreign investors to apply their finances without sense of fault.

So, it could be stated that current situation of laws and regulations lead to disordering of the legal position of foreign investment and investors, even when clearer laws supporting foreign investment are being promulgated as an undeniable requirement. Thus, obstacles should be known and an effort should be made to try to put them aside.

The twenty-year agenda in the Iranian Landscape Document 2025 seems to pay more attention to avoid disruptive regulations and laws regarding to control exports and imports, but there are lots of additional obstacles to be avoided; in this sense, not being up to date is a great obstacle. As it was mentioned, Constitutional Laws, and specifically art. 81, are an obstacle to foreign investment and there has not been a substantial modification. Moreover, this is not the situation only regarding Constitutional Laws, as a similar one can be perceived when having a look on the Five Year Development Plans (specifically the Fifth Development Plan), the Budget Acts, the Law on Encouragement and Protection of Foreign Investment and so on. They all legal texts share a rigorous view on foreign investment.

Therefore the local legal regulation to foreign investment in Iran should be smoothed, this being a requisite for the country development and an advance in front of citizens as well as reducing the dependence of foreign empowerment.

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