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An Analysis of the Effects of Tax Exemptions on Taxpayers and the Government

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ABSTRACT

Tax exemptions are widely used as fiscal policy instruments to promote economic growth, support specific sectors, and advance social justice objectives. Within Iran's legal and economic system, exemptions have become an integral yet controversial component of taxation policy. This article examines tax exemptions as a legal-economic mechanism and critically analyzes their effects on both taxpayers and the government. The study is grounded in a doctrinal analysis of tax law combined with economic reasoning, aiming to assess whether tax exemptions in Iran achieve efficiency, equity, and fiscal sustainability. The analysis demonstrates that tax exemptions generate mixed and often contradictory outcomes. On the taxpayer side, exemptions influence perceptions of tax equity and distributive justice, shape compliance behavior, and affect investment decisions. While certain exemptions may alleviate financial pressure on individuals or encourage productive activities, many disproportionately benefit legal entities and economically powerful actors, thereby weakening horizontal and vertical equity. Complex and fragmented exemption regimes also incentivize tax avoidance and undermine long-term confidence in the tax system. From the government's perspective, tax exemptions produce significant short-term revenue losses and contribute to long-term fiscal imbalance. Persistent erosion of the tax base constrains public budgets, complicates fiscal planning, and limits the state's capacity to provide essential public services. Moreover, extensive and poorly coordinated exemptions weaken economic governance and reduce policy credibility, increasing vulnerability to macroeconomic instability. The findings suggest that the challenges associated with tax exemptions in Iran are systemic rather than incidental. Tax exemptions often fail not because of isolated design flaws, but due to weak legal clarity, insufficient oversight, policy fragmentation, and misalignment with development priorities. The article concludes that tax exemptions should be treated as exceptional and conditional instruments, subject to strict legal justification, transparency, and periodic evaluation. Only within a coherent legal and fiscal framework can tax exemptions contribute to public welfare without undermining equity, efficiency, and fiscal sustainability.

Keywords: Tax exemptions; Tax equity; Public finance; Fiscal sustainability; Tax policy; Iran

Introduction

Taxation has long been regarded as one of the most fundamental instruments of public finance and a primary manifestation of state authority and legitimacy. Through taxation, the government secures the financial resources necessary to provide public goods, maintain social order, and implement economic and social policies. In classical public finance theory, tax revenue constitutes the most stable and predictable source of government income,



distinguishing modern states from earlier political formations that relied on ad hoc levies or coercive extraction (1). From this perspective, taxation is not merely a technical fiscal mechanism but a legal institution deeply embedded in the relationship between the state and citizens. The obligation to pay tax reflects participation in collective life and acceptance of public authority, while the manner in which taxes are imposed and administered shapes public trust in governance (2). Consequently, any deviation from general taxation principles, including the introduction of tax exemptions, must be examined not only in economic terms but also in relation to legal equality, social justice, and state accountability.

Within the Iranian legal system, taxation occupies a constitutionally significant position. The Constitution of the Islamic Republic of Iran explicitly subjects the imposition, modification, and remission of taxes to the principle of legality, requiring that all forms of taxation be established by law. This constitutional commitment reflects a broader public-law tradition that views taxation as a sovereign act constrained by legal norms and institutional oversight (3). Tax exemptions, as exceptions to the general obligation to contribute to public expenses, are therefore not discretionary administrative measures but legislative decisions that must comply with constitutional principles such as equality before the law, proportionality, and the protection of public interests. Iranian financial law scholars emphasize that exemptions, like taxes themselves, derive their legitimacy solely from statutory authorization and cannot be justified through executive practice or informal policy considerations (4). This legal framework establishes the foundational tension that underlies the present study: while tax exemptions are legally permissible, their scope, duration, and justification remain subject to rigorous constitutional and fiscal scrutiny.

Tax exemptions possess an inherently dual nature that complicates their evaluation as policy instruments. On one hand, exemptions are commonly justified as incentives designed to encourage specific economic or social behaviors. Governments employ them to stimulate investment, promote employment, support vulnerable sectors, or advance redistributive objectives aligned with social justice (5). In this sense, exemptions function as indirect expenditure programs, channeling resources toward targeted activities without direct budgetary outlays. On the other hand, exemptions inevitably erode the tax base and reduce government revenue, potentially undermining fiscal sustainability and limiting the state's capacity to finance essential services (6). This tension between incentive effects and revenue loss is particularly pronounced in developing or resource-constrained economies, where the margin for forgone revenue is narrow and public spending needs are substantial. The legal system must therefore mediate between these competing considerations, ensuring that exemptions serve clearly defined objectives without disproportionately weakening the fiscal foundations of the state.

The rationale for government reliance on tax exemptions in Iran has evolved over time, reflecting shifting economic priorities and social concerns. Historically, exemptions have been employed to support agricultural production, small-scale industries, and charitable or religious institutions, drawing upon both economic reasoning and Islamic fiscal principles (7). In contemporary policy discourse, exemptions are often framed as tools for economic growth, regional development, and sectoral support, particularly in areas deemed strategically important or socially sensitive (8). For instance, exemptions granted to newly established industrial units or underdeveloped regions are justified on the grounds that temporary tax relief can offset initial investment risks and generate long-term economic benefits. Similarly, exemptions related to social welfare or inheritance taxation have been defended as mechanisms to alleviate inequality and protect family assets (9). These rationales underscore the multifunctional character of tax exemptions, situating them at the intersection of fiscal policy, social policy, and economic planning.

Despite these stated objectives, the expanding scope of tax exemptions in Iran has raised serious concerns regarding their effectiveness and coherence. One of the central problems is the proliferation of exemptions across multiple sectors and legal instruments, often without systematic evaluation or coordination. Over time, exemptions have accumulated through piecemeal legislative amendments, creating a fragmented and opaque legal landscape that complicates tax administration and compliance (10). The absence of clear criteria for granting, renewing, or terminating exemptions has contributed to legal ambiguity and unequal treatment among taxpayers. Scholars of Iranian tax law argue that such opacity undermines the principle of legal certainty, as taxpayers may struggle to understand their obligations or perceive the system as arbitrary (11). From a public finance perspective, unchecked expansion of exemptions risks transforming targeted incentives into entrenched privileges, disconnected from their original policy justifications.

Another dimension of the problem lies in the inefficiency of many tax exemptions in achieving their intended goals. Empirical and doctrinal analyses suggest that exemptions do not always translate into increased investment, productivity, or employment, particularly when complementary institutional conditions are lacking (12). In some cases, exemptions may simply increase after-tax profits without inducing new economic activity, resulting in pure revenue loss for the government. Moreover, exemptions can distort market competition by favoring certain entities or sectors over others, thereby undermining allocative efficiency and discouraging innovation (13). These distortions are not merely economic concerns but raise legal questions about fairness and equal access to economic opportunities. When exemptions are perceived as benefiting specific groups without transparent justification, they may erode public confidence in the tax system and weaken voluntary compliance.

The behavioral effects of tax exemptions on taxpayers constitute another critical aspect of the research problem. Taxpayer behavior is shaped not only by statutory tax rates but also by perceptions of fairness, complexity, and enforcement. Exemptions that are narrowly targeted and clearly justified may enhance compliance by signaling governmental responsiveness to economic realities. Conversely, overly broad or inconsistently applied exemptions can encourage tax avoidance strategies, as taxpayers seek to reclassify activities or income to fall within exempt categories (14). In extreme cases, exemptions may foster a culture of non-compliance, where paying tax is viewed as optional or negotiable rather than a legal obligation. Iranian tax litigation literature highlights that disputes frequently arise from ambiguous exemption provisions, placing additional burdens on tax dispute resolution bodies and courts (10). These behavioral dynamics underscore the importance of examining exemptions not only as static legal rules but as incentives that interact with taxpayer decision-making.

From the perspective of government finance, tax exemptions have significant implications for revenue stability and fiscal capacity. Foregone revenue resulting from exemptions constrains the government's ability to plan and execute public expenditures, particularly in contexts where alternative revenue sources are limited (1). In Iran, where public budgets are subject to volatility due to external economic factors, the cumulative effect of exemptions can exacerbate fiscal imbalances and increase reliance on non-tax revenues. This reliance, in turn, may weaken the long-term development of a robust tax system grounded in broad-based participation (2). Furthermore, exemptions complicate tax administration by narrowing the tax base and increasing the relative burden on non-exempt taxpayers, potentially intensifying perceptions of injustice and resistance to taxation.

The question of tax justice lies at the heart of the debate over exemptions. Tax justice encompasses both horizontal equity, which requires that similarly situated taxpayers be treated alike, and vertical equity, which justifies differential treatment based on ability to pay (15). While exemptions are often defended as instruments of vertical

equity, their actual distributional effects are not always aligned with this objective. Exemptions granted to capital-intensive sectors or higher-income groups may disproportionately benefit those with greater economic power, thereby undermining redistributive goals (5). In contrast, exemptions designed to support low-income individuals or essential services may advance social justice if properly targeted and monitored. The challenge lies in distinguishing between exemptions that genuinely promote equity and those that merely institutionalize inequality under the guise of policy support.

The research problem addressed in this article emerges from the intersection of these legal, economic, and social considerations. The central issue is whether tax exemptions in Iran, as currently structured and implemented, achieve efficiency, equity, and fiscal sustainability simultaneously, or whether they privilege certain objectives at the expense of others. This inquiry necessitates a careful examination of how exemptions affect taxpayer behavior, influence government revenue, and shape perceptions of tax justice. Rather than assuming that exemptions are inherently beneficial or harmful, the analysis seeks to evaluate their effects within the specific institutional and legal context of Iran.

To address this problem, the article adopts a methodological orientation that combines doctrinal legal analysis with economic reasoning. Doctrinal analysis is employed to examine the statutory foundations, constitutional constraints, and jurisprudential interpretations of tax exemptions within Iranian law, drawing upon authoritative legal scholarship (8). Economic reasoning complements this approach by assessing the incentive effects, revenue implications, and distributional consequences of exemptions, informed by classical and modern public finance theory (13). This integrated methodology allows for a nuanced evaluation that respects the normative dimensions of law while engaging with the empirical realities of fiscal policy. By situating tax exemptions within a legal–economic framework, the article aims to contribute to a more coherent understanding of their role in Iran's tax system and to provide a foundation for informed policy reform.

Conceptual and Legal Framework of Tax Exemptions

In classical public finance, a tax is defined as a compulsory monetary payment imposed by public authority on individuals or legal entities, without direct quid pro quo, for the purpose of financing public expenditures (1). This definition emphasizes three essential elements: compulsion, legality, and public purpose. Iranian legal scholarship has consistently stressed that taxation is not a contractual obligation but a public-law duty arising from membership in the political community (4). The taxpayer, accordingly, is any natural or legal person who, by virtue of law, bears the obligation to contribute to public revenues. This obligation does not depend on consent or individual benefit but on statutory criteria such as income, property, or consumption (8). A tax exemption, by contrast, constitutes a legal exception to this general duty, whereby certain persons, activities, or assets are wholly or partially released from the obligation to pay tax. From a legal perspective, exemptions must be narrowly construed, as they derogate from the principle of general contribution to public burdens (11).

Understanding tax exemptions also requires situating them within the broader structure of taxation in Iran, which is traditionally divided into direct and indirect taxes. Direct taxes are imposed directly on income, profits, or property and are typically assessed on the basis of the taxpayer's economic capacity (2). Examples include income tax, corporate tax, and inheritance tax, each of which targets a specific manifestation of economic ability. Indirect taxes, by contrast, are levied on transactions or consumption and are ultimately borne by the final consumer, even though they are collected from producers or sellers (15). Value-added tax and customs duties exemplify this category. This

distinction is not merely technical; it has significant implications for the design and impact of tax exemptions. Exemptions in direct taxation often aim to influence investment or income distribution, whereas exemptions in indirect taxation may affect consumption patterns and price structures (5). Consequently, any conceptual framework for analyzing tax exemptions must account for the different economic and legal effects associated with each type of tax.

Tax exemptions in Iran can be classified along several dimensions, each reflecting distinct policy rationales and legal techniques. One important classification concerns subject-based exemptions, which focus on the personal or legal status of the taxpayer. Such exemptions may apply to charitable institutions, public bodies, or specific categories of individuals, such as veterans or low-income households (16). The justification for subject-based exemptions often rests on considerations of social justice or public service, recognizing that certain entities either contribute to public welfare in non-monetary ways or lack sufficient capacity to bear the tax burden. However, legal commentators caution that overly broad subject-based exemptions risk undermining horizontal equity by treating similarly situated taxpayers differently without sufficient justification (10). The challenge lies in balancing compassion and fairness with the need for a broad and neutral tax base.

Another important category consists of time-based exemptions, which are granted for a limited duration, typically to support emerging economic activities or transitional policy goals. These exemptions are frequently used as development tools, offering temporary relief to newly established enterprises or investments in underdeveloped regions (12). The underlying assumption is that short-term tax relief can facilitate long-term growth, ultimately expanding the tax base once the exemption period expires. From a legal standpoint, time-based exemptions are often regarded as less problematic than permanent ones, as they incorporate an implicit mechanism for periodic reassessment (3). Nevertheless, in practice, temporary exemptions may be repeatedly extended through legislative amendments, effectively transforming them into permanent privileges and eroding the credibility of fiscal policy.

Sector-based exemptions represent another significant form of differentiation within the tax system. These exemptions target specific branches of economic activity, such as agriculture, industry, culture, or education, and are justified by reference to strategic priorities or perceived social value (7). In Iran, agricultural activities have historically benefited from extensive exemptions, reflecting both economic considerations and religious or cultural norms regarding land and production (17). While sector-based exemptions can support targeted development, they also raise concerns about market distortion and unequal competition. When certain sectors are systematically favored, resources may be diverted away from more productive uses, undermining overall economic efficiency (13). Legal analysis thus demands careful scrutiny of whether sectoral exemptions remain aligned with their original objectives or have become entrenched interests.

A further distinction can be drawn between permanent and temporary exemptions, which cuts across the other classifications. Permanent exemptions are embedded in the legal structure of taxation and apply indefinitely unless repealed by legislation. Such exemptions are often associated with constitutional or fundamental policy commitments, such as exemptions for certain public institutions or religious activities (4). Temporary exemptions, by contrast, are explicitly time-limited and contingent upon specific conditions. From the perspective of legal theory, permanent exemptions pose a greater challenge to the principle of equality before public burdens, as they institutionalize differential treatment over time (15). Temporary exemptions, while more flexible, require effective monitoring and enforcement to ensure that they do not outlive their intended purpose.

The legal sources of tax exemptions in Iran form a multilayered framework, beginning with the Constitution and extending through ordinary legislation and sector-specific statutes. At the constitutional level, the principle of legality of taxation establishes that any exemption must be grounded in law, reflecting the broader commitment to parliamentary sovereignty in fiscal matters (3). This principle serves as a safeguard against arbitrary or discretionary exemptions, ensuring that deviations from general taxation norms are subject to democratic deliberation. The Direct Taxation Act constitutes the primary statutory source of tax exemptions, detailing their scope, conditions, and beneficiaries across various tax categories (8). In addition to this central statute, numerous special laws and sectoral regulations introduce exemptions tailored to specific activities or institutions, contributing to the complexity of the legal landscape (10). The coexistence of these multiple sources underscores the need for systematic interpretation and harmonization to prevent inconsistency and overlap.

Beyond positive law, the jurisprudential and public-law foundations of tax exemptions play a crucial role in shaping their legitimacy and application. The principle of legality of taxation, as a cornerstone of public law, demands that both the imposition of taxes and the granting of exemptions be clearly defined and foreseeable (11). This requirement is closely linked to the rule of law, which emphasizes transparency, predictability, and accountability in the exercise of public power. Legal certainty is particularly important in the tax context, where ambiguity can lead to disputes, unequal enforcement, and erosion of trust (14). From this perspective, exemptions must be drafted with precision and applied consistently to avoid undermining the normative coherence of the tax system.

The principle of equality before public burdens constitutes another foundational element in the legal assessment of tax exemptions. This principle holds that all members of society should contribute to public expenses in proportion to their ability to pay, unless objective and reasonable grounds justify differential treatment (1). Exemptions, by definition, create inequality among taxpayers, but such inequality may be legally acceptable if it serves legitimate objectives and respects proportionality. Iranian legal scholars argue that exemptions must be evaluated in light of both horizontal and vertical equity, ensuring that they do not arbitrarily favor certain groups or exacerbate social disparities (5). Failure to adhere to this principle risks transforming exemptions from instruments of justice into sources of privilege.

Theoretical justifications for tax exemptions further illuminate their role within the fiscal system. Economic incentive theory views exemptions as tools to influence behavior by altering relative prices and returns (13). By reducing tax liability in targeted areas, the government can encourage investment, innovation, or employment in sectors deemed socially beneficial. This approach treats tax exemptions as indirect subsidies, substituting foregone revenue for direct expenditure. While theoretically appealing, incentive-based exemptions require careful calibration to ensure that behavioral responses justify the fiscal cost (2). Without empirical support, incentives may simply reward activities that would have occurred anyway, resulting in inefficient allocation of public resources.

Social justice and redistribution provide another important theoretical foundation for tax exemptions. From this perspective, exemptions are justified as mechanisms to protect vulnerable groups, reduce inequality, and promote social cohesion (16). Exemptions related to basic needs, charitable activities, or inheritance may serve redistributive goals by alleviating the tax burden on those with limited capacity to pay (9). This justification resonates with both secular and Islamic conceptions of justice, which emphasize solidarity and mutual responsibility. However, the redistributive effectiveness of exemptions depends on their design and targeting. Poorly structured exemptions may benefit higher-income groups disproportionately, undermining their normative justification (7).

Finally, the correction of market failures constitutes a further rationale for tax exemptions. Market failures such as externalities, public goods, or information asymmetries may justify government intervention through fiscal measures (5). Tax exemptions can be used to internalize positive externalities, for example by supporting education, research, or environmental protection. In such cases, exemptions aim to align private incentives with social benefits, complementing regulatory approaches. Nonetheless, from a legal-economic standpoint, exemptions must be evaluated against alternative instruments, such as direct subsidies or regulation, to determine whether they represent the most effective and least distortive means of intervention (6). This comparative perspective reinforces the need for a coherent conceptual and legal framework as the basis for assessing the role of tax exemptions in Iran's fiscal system.

Challenges and Structural Deficiencies of Tax Exemptions

Despite their normative justifications and policy ambitions, tax exemptions in Iran have increasingly been criticized for failing to achieve their intended economic and social objectives. One of the most persistent structural deficiencies associated with tax exemptions is their direct impact on government tax revenues and the resulting fiscal imbalance. Tax revenue constitutes the backbone of sustainable public finance, and any systematic reduction in the tax base constrains the government's capacity to finance public goods and services (1). In the Iranian fiscal structure, where public expenditures continue to expand due to demographic pressures and social commitments, extensive exemptions have significantly reduced effective tax collection (2). The cumulative effect of multiple exemptions across sectors has led to a narrowing of the tax base, forcing the government to rely more heavily on volatile or non-tax revenues. This situation undermines fiscal stability and weakens long-term budget planning, particularly when exemptions are granted without clear revenue-offset mechanisms or periodic evaluation (6).

The erosion of tax revenues resulting from exemptions is closely linked to broader fiscal imbalances. When a substantial portion of potential tax income is foregone, the government faces difficult trade-offs between increasing tax pressure on non-exempt taxpayers, reducing public spending, or resorting to deficit financing. Each of these options carries economic and legal risks. Increasing the tax burden on compliant taxpayers may intensify perceptions of unfairness and reduce voluntary compliance (5), while expenditure cuts can negatively affect public welfare and development goals. Deficit financing, on the other hand, may exacerbate inflationary pressures and undermine macroeconomic stability. In this sense, tax exemptions contribute not merely to revenue loss but to systemic fiscal fragility, challenging the state's ability to fulfill its constitutional and social obligations (4).

Another major challenge associated with tax exemptions is their role in expanding opportunities for tax avoidance and evasion. Exemptions introduce complexity into the tax system by creating differentiated treatment for various activities, assets, or taxpayers. This complexity increases the scope for strategic behavior, as taxpayers may attempt to reclassify income or restructure transactions to fall within exempt categories (14). Iranian tax litigation experience indicates that disputes frequently arise over the interpretation and application of exemption provisions, reflecting both ambiguity in legislative drafting and deliberate exploitation by taxpayers (10). When exemptions are broadly worded or poorly defined, they blur the boundary between lawful tax planning and unlawful evasion, weakening enforcement and increasing administrative costs.

The expansion of avoidance and evasion opportunities also undermines the moral foundations of the tax system. Tax compliance is influenced not only by enforcement mechanisms but also by perceptions of fairness and legitimacy. When exemptions are perceived as loopholes that benefit certain groups disproportionately, taxpayers

may question the rationale for complying with tax obligations themselves (1). This erosion of tax morale can have long-term consequences, fostering a culture in which tax avoidance is normalized and compliance is viewed as optional rather than obligatory. From a public-law perspective, such outcomes conflict with the principle of equality before public burdens, which requires that all members of society contribute fairly to the financing of public expenses (15).

Unequal treatment of taxpayers constitutes another structural deficiency inherent in the current exemption regime. Tax exemptions, by definition, differentiate among taxpayers, but the legitimacy of such differentiation depends on objective and reasonable criteria. In practice, however, exemptions in Iran have often resulted in unequal treatment without sufficient justification, favoring certain sectors, institutions, or economic actors over others (8). This unequal treatment distorts competition by granting artificial advantages to exempt entities, enabling them to operate at lower costs than their non-exempt counterparts. Over time, such distortions can discourage efficient firms, misallocate resources, and reduce overall economic productivity (13). The legal concern here extends beyond economic efficiency to the integrity of the legal order, as persistent inequality undermines confidence in the neutrality and impartiality of the law (11).

Closely related to unequal treatment is the problem of weak transparency and legislative ambiguity surrounding tax exemptions. Transparency is a core requirement of the rule of law, particularly in fiscal matters where obligations and privileges must be clearly defined (3). Yet many exemption provisions in Iranian tax legislation lack precise definitions, clear eligibility criteria, or explicit time limits. This ambiguity complicates both taxpayer understanding and administrative enforcement, increasing the likelihood of inconsistent application (10). Moreover, exemptions are often scattered across multiple statutes and sectoral regulations, making it difficult to obtain a comprehensive view of their scope and impact. Such opacity not only hinders effective policy evaluation but also creates fertile ground for discretionary decision-making and unequal enforcement (14).

Administrative inefficiency and weak oversight further exacerbate the structural shortcomings of tax exemptions. Effective exemption policy requires robust administrative capacity to verify eligibility, monitor compliance, and assess outcomes. However, the tax administration often lacks the resources or institutional coordination necessary to perform these functions effectively (12). In the absence of reliable data and systematic oversight, exemptions may persist long after their original justification has disappeared. This administrative weakness also limits the government's ability to detect abuse or non-compliance, allowing exemptions to be exploited by entities that do not meet statutory conditions (6). From a legal standpoint, inadequate oversight undermines the principle of legality, as statutory rules fail to translate into predictable and enforceable outcomes (11).

The fragmentation of tax policy represents another systemic issue contributing to the ineffectiveness of tax exemptions. Exemptions are often introduced as isolated measures responding to specific political or economic pressures, rather than as components of a coherent fiscal strategy (2). This piecemeal approach leads to inconsistencies and overlaps among different exemption regimes, reducing their overall effectiveness and complicating administration. The lack of coordination between tax policy and broader economic planning further weakens the impact of exemptions on development objectives. When exemptions are not aligned with investment, employment, or industrial policies, their potential benefits are diluted, and their costs become more pronounced (5). Such fragmentation reflects a structural failure to integrate fiscal instruments within a unified policy framework.

Rent-seeking behavior and exemption abuse constitute perhaps the most problematic consequences of an expansive and poorly regulated exemption system. Rent-seeking arises when individuals or groups expend

resources to secure preferential treatment through legal or political channels, rather than engaging in productive economic activity (13). In the context of tax exemptions, rent-seeking manifests in lobbying for special privileges, exploiting ambiguities in legislation, or leveraging institutional weaknesses to obtain or extend exemptions (10). These practices divert resources away from productive uses and undermine the credibility of public institutions. From a public-law perspective, rent-seeking associated with tax exemptions raises serious concerns about equality, accountability, and the proper exercise of legislative power (3).

The persistence of exemption abuse also reflects weak alignment between tax exemptions and development priorities. Although exemptions are often justified as tools for economic growth or social development, their actual distribution does not always correspond to strategic national objectives (7). In some cases, exemptions benefit mature or capital-intensive sectors that require little support, while emerging or labor-intensive activities remain underfunded. This misalignment reduces the developmental impact of exemptions and may even exacerbate regional or social disparities (5). When exemptions are granted without rigorous impact assessment or sunset provisions, they risk becoming entrenched entitlements disconnected from evolving economic realities (12).

Taken together, these challenges reveal that the shortcomings of tax exemptions in Iran are not isolated technical flaws but manifestations of systemic failure. Revenue loss, avoidance and evasion, inequality, opacity, administrative weakness, policy fragmentation, rent-seeking, and misalignment with development priorities are interrelated phenomena that reinforce one another. Addressing any single issue in isolation is unlikely to produce meaningful reform. Instead, a comprehensive reassessment of the exemption regime is required, grounded in legal principles and informed by economic analysis. Such reassessment must consider not only whether exemptions exist, but how they are designed, implemented, monitored, and integrated within the broader fiscal and legal system. Only through this systemic lens can the true causes of exemption failure be understood and the foundations laid for more effective and equitable tax policy.

Effects of Tax Exemptions on Taxpayers and Government

The effects of tax exemptions on taxpayers constitute one of the most contested dimensions of fiscal policy, as exemptions directly shape perceptions of equity, influence economic behavior, and affect the long-term relationship between citizens and the state. From the standpoint of tax equity and distributive justice, exemptions introduce deliberate deviations from the principle that public burdens should be shared according to ability to pay. In theory, such deviations may be justified when they promote vertical equity by relieving disadvantaged groups or supporting socially valuable activities (1). In practice, however, the distributive consequences of tax exemptions in Iran have often been ambiguous. Exemptions granted to certain economic actors, particularly those with greater access to capital or institutional influence, may disproportionately benefit higher-income individuals or large legal entities, thereby weakening redistributive objectives (5). This outcome conflicts with the normative expectation that exemptions should mitigate inequality rather than entrench it, raising fundamental questions about fairness within the tax system (15).

Tax exemptions also exert significant behavioral effects on taxpayers, shaping compliance attitudes, avoidance strategies, and investment decisions. When exemptions are perceived as fair, transparent, and aligned with genuine economic or social goals, they may enhance voluntary compliance by signaling that the tax system is responsive to real-world conditions (2). Conversely, when exemptions appear arbitrary or selectively applied, they can undermine tax morale and encourage strategic behavior aimed at minimizing tax liability rather than maximizing

productive activity (14). In Iran, the complexity and multiplicity of exemption provisions have increased incentives for taxpayers to engage in avoidance through income reclassification or organizational restructuring (10). Such behavior may be legally permissible in some cases, but it diverts resources toward tax planning rather than productive investment, diminishing the overall efficiency of the economy.

The differential impact of tax exemptions on individuals and legal entities further illustrates the uneven distribution of their effects. Individual taxpayers often benefit from exemptions related to basic needs, inheritance, or limited income thresholds, which can alleviate financial pressure and contribute to social protection (9). However, the aggregate fiscal impact of individual-level exemptions is typically modest compared to exemptions granted to legal entities, particularly corporations operating in favored sectors (8). Legal entities are better positioned to exploit exemption regimes due to their access to legal expertise and organizational flexibility, enabling them to structure operations in ways that maximize tax advantages (13). This asymmetry risks shifting the tax burden toward individuals and small businesses that lack similar capacities, thereby undermining horizontal equity and public confidence in the fairness of taxation (11).

A related distinction concerns the differential effects of exemptions on productive versus non-productive sectors of the economy. Exemptions are often justified as incentives for productive activities such as manufacturing, agriculture, or service provision, with the expectation that tax relief will stimulate output, employment, and value creation (7). In some cases, exemptions have indeed supported the expansion of certain productive activities, particularly where complementary infrastructure and market access are available (12). However, exemptions have also been extended to activities that contribute little to long-term development or productivity, including speculative or rent-based sectors (5). When non-productive activities receive preferential tax treatment, resources may be diverted away from sectors with higher social returns, reducing the overall effectiveness of exemption policies and distorting economic incentives (13).

The effectiveness of tax exemptions as incentives for employment, production, and service provision depends heavily on their design and implementation. Well-targeted exemptions with clear eligibility criteria and time limits can reduce initial costs for new enterprises and encourage job creation, particularly in labor-intensive sectors (2). Yet the empirical record suggests that many exemptions fail to generate proportional increases in employment or output, especially when structural constraints such as limited access to finance or weak demand persist (6). In such contexts, exemptions may simply increase after-tax profits without inducing additional economic activity, resulting in a transfer of public resources to private actors without corresponding social benefits (1). This outcome highlights the importance of evaluating exemptions not in isolation but in relation to broader economic conditions and complementary policies.

Beyond immediate economic effects, tax exemptions influence the long-term credibility of the tax system in the eyes of taxpayers. Credibility depends on the perception that tax rules are stable, predictable, and applied consistently (3). Frequent changes to exemption regimes, ad hoc extensions, or selective enforcement can erode this perception, leading taxpayers to view taxation as uncertain or negotiable (14). Over time, diminished credibility undermines compliance and weakens the social contract underlying taxation. From a public-law perspective, this erosion of trust represents a significant cost of poorly designed exemption policies, as it compromises the legitimacy of fiscal governance (11).

Turning to the effects of tax exemptions on government, the most immediate consequence is their impact on public revenue. In the short term, exemptions reduce tax inflows by narrowing the tax base, often without

transparent accounting of foregone revenue (1). While policymakers may anticipate that incentive effects will compensate for this loss through increased economic activity, such outcomes are uncertain and typically materialize, if at all, only in the long term (2). The mismatch between short-term revenue loss and uncertain long-term gains poses significant challenges for fiscal planning, particularly in environments characterized by budgetary constraints and competing expenditure priorities (6). This trade-off underscores the need for careful assessment of whether exemptions represent efficient use of public resources.

In the long term, the cumulative effect of tax exemptions can substantially weaken fiscal sustainability. Persistent revenue erosion limits the government's ability to finance essential public services, invest in infrastructure, and respond to economic shocks (4). When exemptions become entrenched features of the tax system, reversing them may prove politically difficult, even if their original justification has disappeared (3). This rigidity reduces fiscal flexibility and increases vulnerability to external or internal economic pressures. Moreover, reliance on exemptions as policy tools may divert attention from more comprehensive tax reforms aimed at broadening the base and improving administration (8).

Budget deficits represent a direct manifestation of the tension between exemptions and fiscal sustainability. When revenue losses from exemptions are not offset by increased growth or alternative revenue sources, deficits may widen, necessitating borrowing or monetary financing (5). Such measures can have inflationary effects and undermine macroeconomic stability, particularly in economies with limited fiscal space (13). From a legal perspective, persistent deficits raise concerns about intergenerational equity, as future taxpayers may bear the cost of current exemption policies (1). This dynamic highlights the broader social implications of exemption-induced fiscal imbalance.

Tax exemptions also affect the government's capacity to provide public services, which are central to social welfare and economic development. Reduced revenue constrains investment in education, healthcare, infrastructure, and social protection, potentially offsetting any benefits derived from exemptions (6). In some cases, exemptions granted to private service providers may be intended to supplement public provision, but without adequate oversight, such arrangements risk compromising service quality or accessibility (16). The resulting gap between public expectations and service delivery can further erode trust in government and exacerbate social inequality.

The credibility of economic governance and policy coherence is also influenced by the use of tax exemptions. A tax system characterized by numerous exemptions may appear fragmented and inconsistent, signaling weak commitment to rule-based governance (3). Investors and economic actors value predictability and transparency, and uncertainty surrounding exemption policies can deter long-term investment (12). When exemptions are perceived as subject to political influence or rent-seeking, they may undermine confidence in the impartiality of economic policy (10). This reputational cost can be particularly damaging in efforts to attract domestic and foreign investment.

Finally, the relationship between tax exemptions and macroeconomic stability illustrates the broader trade-offs inherent in exemption policy. While exemptions may support specific sectors or activities in the short term, their aggregate effect on revenue, deficits, and inflation can pose risks to macroeconomic balance (5). Excessive reliance on exemptions may weaken automatic stabilizers within the tax system, reducing the government's ability to respond countercyclically to economic fluctuations (13). In this sense, exemptions are not neutral instruments but interventions with far-reaching implications for economic stability and governance.

Overall, the effects of tax exemptions on taxpayers and government reveal a complex pattern of trade-offs rather than unequivocal benefits. Exemptions may promote equity or growth under certain conditions, but they also risk undermining fairness, efficiency, revenue stability, and institutional credibility when poorly designed or excessively applied. Understanding these trade-offs is essential for evaluating the role of tax exemptions within Iran's fiscal system and for informing future reform efforts that seek to balance economic incentives with legal principles and public interest considerations.

Conclusion

The analysis undertaken in this article demonstrates that tax exemptions occupy a paradoxical position within Iran's fiscal and legal system. They are simultaneously conceived as instruments of economic promotion and social justice and experienced as sources of fiscal fragility, inequality, and institutional weakness. This duality underscores the central conclusion that tax exemptions cannot be evaluated in isolation or through abstract normative claims alone. Their effectiveness depends on how they are designed, justified, implemented, monitored, and integrated into the broader structure of taxation and public finance. When these elements are misaligned, tax exemptions cease to function as policy tools and instead become structural liabilities.

From a legal perspective, tax exemptions represent deliberate deviations from the general principle that all members of society must contribute to public expenses in proportion to their economic capacity. Such deviations are not inherently illegitimate, but they demand heightened justification and strict adherence to constitutional and public-law principles. The analysis shows that, in practice, many exemptions lack the precision, transparency, and proportionality required to preserve equality before public burdens. Instead of serving clearly articulated public interests, exemptions often generate unequal treatment among taxpayers, weaken legal certainty, and blur the boundary between lawful incentive policies and unjustified privilege. Over time, this erosion of legal coherence undermines confidence in the neutrality and authority of the tax system.

Economically, the promise of tax exemptions as engines of growth and development has proven uneven and frequently overstated. While exemptions may reduce costs and risks for certain activities in the short term, their long-term impact on investment, employment, and productivity is far from guaranteed. In many cases, exemptions have failed to generate additional economic activity commensurate with the revenue they forego. Instead, they have encouraged tax planning, income shifting, and rent-seeking behavior, diverting resources away from productive uses. This outcome highlights a fundamental insight of the analysis: tax exemptions are not substitutes for sound economic fundamentals, effective institutions, or coherent development strategies. Without these complementary conditions, exemptions tend to reward existing advantages rather than create new opportunities.

The distributive consequences of tax exemptions further complicate their evaluation. Although exemptions are often defended as mechanisms for advancing social justice, their actual effects frequently contradict this rationale. Benefits are disproportionately captured by legal entities and economically powerful actors who possess the expertise and flexibility to navigate complex exemption regimes. Individual taxpayers and small enterprises, by contrast, bear a relatively greater share of the tax burden and enjoy fewer opportunities to benefit from exemptions. This imbalance weakens both horizontal and vertical equity, reinforcing perceptions that the tax system favors certain groups at the expense of others. Such perceptions are particularly damaging in contexts where tax compliance relies heavily on voluntary cooperation rather than coercive enforcement.

For government, the fiscal implications of tax exemptions are both immediate and cumulative. In the short term, exemptions reduce tax revenues and constrain budgetary flexibility, often without transparent accounting of their true cost. In the long term, persistent erosion of the tax base undermines fiscal sustainability, increases vulnerability to economic shocks, and limits the state's capacity to invest in public goods and social services. These pressures are exacerbated when exemptions become politically entrenched and resistant to reform, even after their original objectives have been met or rendered obsolete. The resulting rigidity weakens economic governance and diminishes the credibility of fiscal policy.

A key conclusion emerging from this study is that the challenges associated with tax exemptions in Iran are systemic rather than incidental. Revenue loss, inequality, avoidance, administrative weakness, policy fragmentation, and misalignment with development priorities are mutually reinforcing phenomena. Attempts to address individual problems without confronting the broader structural context are unlikely to succeed. Effective reform requires a comprehensive reassessment of the role of tax exemptions within the fiscal system, grounded in both legal principles and economic reasoning. Such reassessment must move beyond the question of whether exemptions should exist and instead focus on how they can be constrained, targeted, and evaluated to serve clearly defined public purposes.

This analysis suggests that tax exemptions should be treated as exceptional and conditional instruments, not permanent features of the tax landscape. Their justification must be explicit, their scope narrowly defined, and their duration limited. Regular evaluation mechanisms are essential to assess whether exemptions achieve their stated objectives and to determine whether they should be modified or terminated. Transparency in legislative drafting and administrative implementation is equally crucial, as it enhances legal certainty, facilitates oversight, and reduces opportunities for abuse. Without such safeguards, exemptions risk becoming opaque entitlements rather than accountable policy tools.

Ultimately, the effectiveness of tax exemptions must be measured against their impact on the integrity of the tax system as a whole. A system characterized by widespread exemptions, inconsistent application, and weak enforcement cannot sustain public trust or fiscal stability over the long term. By contrast, a tax system that prioritizes broad participation, fairness, and predictability is better equipped to support economic development and social cohesion. The central lesson of this study is therefore not that tax exemptions should be categorically rejected, but that they must be subordinated to the overarching goals of equity, efficiency, and sustainability. Only within such a framework can tax exemptions contribute meaningfully to public welfare rather than undermine it.

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Authors' Contributions

All authors equally contributed to this study.

Declaration of Interest

The authors of this article declared no conflict of interest.

Ethical Considerations

All ethical principles were adhered in conducting and writing this article.

Transparency of Data

In accordance with the principles of transparency and open research, we declare that all data and materials used in this study are available upon request.

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