Iran's Economy: Status, Problems, and Prospects

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An impartial evaluation of the 1979 Revolution's impact on Iran's society and polity may still require longer than a single generation to gain proper perspective. Its economic legacy, however, is easier to appraise. Leaders of the Islamic Republic, who focus solely on certain impressive changes in the physical landscape and a few quantitative indices, claim that Iran's socio-economic achievements in the last 25 years are the envy of its neighbors. The opposition, in turn, ignoring countless internal and external adversities faced by the regime during the period, tends to dismiss the clerics' claims out of hand by questioning the veracity and reliability of official data. This review attempts to examine these disparate judgments in an impartial and objective manner with the help of broader–based, less selective data.[1]

The Regime's Bill of Particulars

The Islamic Republic's leadership, its surrogate Friday prayer *imams*, and its partisan supporters at home and abroad seize upon every opportunity to boast about the Revolution's blessings and bounties. Reams of statistics are offered to show vast expansion of basic infrastructures (highways, railways, rural roads, irrigation dams, air and sea port terminals); improvements in modern means of communication (radio and TV coverage, fax, cell phones, internet connections); extension of gas lines to hundreds of cities; eye-catching urban beautification and recreational facilities; and other brick-and-mortar sites. Self-sufficiency in some farm products, capacity increases in electric power generation and rural electrification; advances in industrial production and exports (basic metals, chemicals, oil and gas) and modern defense build-up (from home-made tanks, ships and air planes to long-range ballistic missiles, and nuclear capabilities) are touted as Islamic trophies. Endless Friday sermons and a raft of selective data are presented to show notable achievements in education evidenced by increases in adult literacy, student attendance at all levels, published professional papers, and winners in scientific Olympiads. Improvements in the health field are said to include higher life expectancy, lower infant mortality, the number of physicians and nurses per capita, public access to safe water and sanitation, some showcase feats in medical and health care, and, most spectacularly, population control. Equally strongly, emphasis is placed on sustaining an "adequate" standard of living for a growing population during the Iran-Iraq war, avoiding prolonged shortages of essential goods and services, and increasing per capita food intake and energy consumption after the war, while relying on only a minimum of financial and technical support from abroad.

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[1] An accurate account of Iran's economic performance is handicapped by the paucity, unreliability, and inconsistency of essential data. Official statistics published by various state agencies often contradict each other or lack detailed coverage. Data on public enterprises' balance sheets as well as on the financial status of *bonyads* (organizations set up after the revolution that control a sizeable segment of Iran's economy) are totally unavailable for public scrutiny.

The regime's opposition—monarchists, secularists, democracy advocates, human-rights activists, and old Islamic Marxists—point, in turn, to such setbacks as slow economic growth, low per capita income, protracted unemployment, double-digit inflation, widening income gaps, widespread poverty, ill-gotten wealth by many clerics, and institutionalized corruption since the revolution. Neutral observers, in their turn, raise some questions regarding the regime's claims of achievement. The following observations exemplify the arguments advanced by these outside observers for how to make a more balanced assessment of the post-revolution economy.

First, the raw quantitative data on specific social welfare indicators and infrastructure projects cited by the regime need to be adjusted and qualified for the content of education and its suitability for the country's employment needs; the skills of new teachers and health care providers; the quality of health care; the quake-resistant strength of high-rise towers; the safety of public roads and transport vehicles; and the opportunity costs of import-substituting products.

Second, the invaluable contributions of assets inherited from the previous regime—a nationwide modern infrastructure, sizeable industrial production capacity, a thriving oil industry, a strong defense capability, a vast cadre of talented and experienced public servants and business managers, and a thick stack of blueprints for potential projects—form an integral part of the success stories trumpeted by the regime. Without these facilities, the clerical regime would hardly have been able repel the well-equipped Iraqi army, withstand U.S. sanctions and the international arms embargo, and continue its economic and defense build-up. In fact, the Islamic regime is hard-pressed to show any of its showcase projects to be of its own initiative and not built upon foundations already in place.

Third, and finally, the regime's responsibility for their undeniable deficiencies and shortcomings ought to be frankly acknowledged, and not attributed to such excuses as the Shah's "misdeeds;" disruptions caused by the Revolution; damages and distractions from the "imposed war" with Iraq; U.S. trade and financial sanctions; oil price fluctuations; antagonistic Western negative publicity; terrorist acts by anti-revolutionary forces; and frequent natural disasters (earthquakes, drought, and floods). While the negative impact of these elements should not be overlooked or underestimated, the regime's responsibility for creating them should not be ignored. Official praise for the American Embassy takeover and seizing of hostages as "the second revolution," continuing the war with Iraq after l982 in spite of a UN cease-fire resolution and against experts' advice, alleged involvements in some high-profile international terrorist acts, and assistance to terrorist organizations are clearly among self-inflicted wounds and not beyond the regime's control.

Economic Development in a Crisis Mode

Disregarding the opposition's doubts about the genuineness of the regime's statistical data and taking official reports at their face value, Iran's post-revolution economy has thus far experienced a few successes, some partial setbacks, and a number of acknowledged failures. Four separate phases with different slogans, strategies, and policies have taken up the last 25 years. In the first phase covering the early post-revolution period, the economy was managed in an *ad hoc*, improvised, and inconsistent manner. In the midst of political turmoil, economic confusion, and social conflicts, the regime toyed with a bizarre doctrine called the *economics of divine unity*, whose basic premise was not scarcity and the need for rational allocation, but material plenty and the task of equitable income distribution. This counterintuitive thesis, concocted by a clueless theoretician of the regime, was a poorly-conceived and badly-distorted leftist ideology that denied the sanctity of private property and advocated administered distribution of wealth and income.[2] The goal was distribution before growth. Meanwhile, the Revolutionary Council, appointed by Ayatollah Khomeini, embarked upon a radical transformation of the economy from its basically Western-oriented free-enterprise system to a state-managed theocratic oligarchy. Thousands of private properties and business firms belonging to the Shah's associates were confiscated without compensation. A series of further radical decisions, later sanctioned by the 1979 Islamic Constitution, involved the wholesale nationalization of private banks, insurance companies, major industrial enterprises, agribusinesses, and all basic industries. The hasty replacement of experienced and knowledgeable private owner-managers by young revolutionary firebrands and rapacious mullahs resulted in a disastrous decline in production and income, which was accompanied by high inflation and unemployment. Between l978/79 and 1980/81, GDP fell 20 percent in real terms, and the value of the Iranian *rial* plummeted from Rls 70=$l to Rls 235=$1.

The second phase, coinciding roughly with the 1980-1988 Iran-Iraq war, followed an ideology based on pursuing an ascetic, egalitarian, and self–sacrificing life. The economic strategy adopted by the regime, far beyond the exigencies of managing a wartime economy, reflected a pseudo-Marxist model. Promoted and led by an Islamic Marxist fanatic openly hostile to American capitalism and multinational institutions,[3] the new strategy involved extensive state intervention in the economy, regulation of business transactions, rationing, and Big Brother supervision. During this period, wartime conditions and American economic sanctions were given as reasons to further expand government ownership and operation. The official goal was to insure national self-sufficiency and secure Islamic social justice. One of the administration's prime targets was to encourage a high rate of population growth designed to create "20-million soldiers of Islam." This ill-conceived policy has contributed significantly to Iran's current intractable high unemployment and low national productivity. By keeping the official dollar value of the Iranian *rial* artificially low at the 1979 level, the weak economy was further exposed to serious cost/price distortions, a rent-seeking business culture, and a costly and unfair subsidy system. To cope with the resulting stubborn inflation, a vast array of wage, price, and exchange controls were imposed, rationing of essential consumer goods was intensified, and imports were compressed through strict foreign currency allocations. The outcome was, not surprisingly, dismal. GDP in real terms during the eight-year period of the war with Iraq declined by 1.8 percent a year on average, with the result that the real national product in l988/89 was only equal to that of 15 years earlier. With the population already up by 60 percent, per capita income was down to 55 percent of the1977/78 level. Unemployment reached nearly 16 percent. Inflation climbed to 28.2 percent—the highest since the end of World War II. Budget deficits exceeded 44 percent of total expenditure, and 9 percent of GDP. The exchange value of the *rial* in the gray market reached 20 times the official rate.

The third phase began with the 1988 ceasefire in the Iran-Iraq war, and covered roughly the two five-year development plans. The massive devastation left by the Revolution itself and the enormous destruction wrought by the ruinous 8-year war with Iraq had literally exhausted the people's patience. With the death of Ayatollah Khomeini in 1989, a number of young technocrats and progressive clerics began to realize that the early revolutionary slogan of "Islam is the solution" was no longer operative. A group loyal to then-President Rafsanjani—a businessman by profession and a clergyman by avocation—spearheaded a movement to revamp the economy in the direction of liberalization, privatization, and global participation. The first Five-Year Development Plan (1989-1993) adopted a multi-pronged strategy aimed at reconstructing war-torn areas, expanding basic infrastructure neglected during the war, and reviving the private

[2] For details of this thesis see A. H. Bani Sadr, *Eqtesad-e Towheedi* (Tehran: no date; no publisher).
[3] See Mir Hossein Musavi's speech before the Majles, in *Ettela'at*, 6 Bahman, 1360 (January 6, 1981).

sector under a structural adjustment program called *ta'deel eqtesadi*.[4] The plan promised to transform the war economy into a market-oriented, investment-driven, and more efficient system through trade liberalization, wage-price deregulation, privatization of state enterprises, and other economic reforms. Disregarding the earlier emphasis on self-sufficiency, the government began actively seeking foreign credit from the World Bank and other international financial institutions. Earlier strategies that had reflected Bani Sadr's economic dilettantism and Musavi's obsessive interventionism were overtaken by Rafsanjani's *perestroika.* And, above all, Musavi's disastrous pronatal policy was replaced by strict population controls.

The paradigm change was initially successful. Large industrial excess capacity unused during the war, the release of soldiers from war duties, and, particularly, rising oil export revenues following Iraq's invasion of Kuwait helped raise both sectoral and aggregate economic growth in the first three years of the plan—allowing such growth to overshoot its initial targets. The number of price-controlled items was cut drastically, and import restrictions were substantially removed. Under a limited but highly controversial program, some 200 public enterprises were privatized. However, advances on the liberalization and deregulation fronts were short-lived. In response to the removal of import and exchange restrictions, private consumption exceeded planned projections, rising 19.5 percent in 1990 alone, compared to only 2.5 percent in 1989. A lack of discipline in the conduct of the plan's other mandates was equally responsible for a series of emerging bottlenecks. The first setback appeared in March 1993 with a disastrous decision to unify the 12 different exchange rates into a single "floating" rate of Rls 1600 to the U.S. dollar—replacing the long-outdated basic parity rate of Rls 70. Without complementary monetary and fiscal policies, and a series of other misguided decisions, the unification decision badly backfired. Imports rose from $l0.6 billion in 1988-89 to $25.2 billion in 1991-92 largely on short-term export credits. The balance-of-payments experienced huge deficits, exchange reserves were soon exhausted, banks were unable to meet their short-term repayment obligations, and the Central Bank had to engage in a series of excruciatingly difficult bilateral negotiations with Iran's trade partners. As a result, by mid-1993, not only did the structural adjustment strategy lose steam, but many restrictions in foreign trade and exchange had to be reinstated. The unified exchange rate was finally abandoned in December 1993; price controls were re-imposed; and severe new penalties (*taa'zeerat*) were set for violators. Except for the energy sector, all other sectors fell short of their planned targets. Both public and private consumption exceeded their targets, and aggregate investment fell below its projected level. Despite strict price controls and huge subsidies, the consumer price index ended up with an average increase of 19 percent a year for the period. Iran's foreign debt reached 11.4 percent of GDP—the highest ever.

The second plan was scheduled to begin in March of 1994. Significant internal and external imbalances required a delay, however, so that the government could place its financial house in order. In May 1994, a new and more depreciated rate of Rls 1750=$1 was announced, and a cheaper preferential rate of Rls 2345 was introduced to encourage non-oil exports. As a result, a measure of improvement was achieved in reducing monetary and exchange imbalances. Nevertheless, GDP growth fell to an anemic 1.6 percent—the lowest in six years—and inflation remained high at 35 percent.[5] After a year hiatus, the Second Development Plan for 1995-1999 went into effect in March 1995. Still advocating economic liberalization and privatization, the plan began with a new and vastly different stabilization program called *tasbeet eqtesadi*—a code word for renewed regulation and economic controls.

[4] For details see *A summarized version of the First Five-Year Plan 1989-1993* (Tehran: Plan Organization, 1990)

[5] For an evaluation of the First Plan, see Jahangir Amuzegar, *Iran's Economy under the Islamic Republic* (London: I.B.Tauris, 1997), Ch.9.

The new plan had a number of qualitative objectives and several quantitative targets similar to those of the first, but progress in achieving its core objectives was again partial at best. The plan's last two years, which coincided with Khatami's presidency, exemplified classic economic stagflation. An intellectual preacher and a clerical peacenik untrained and uninterested in economics, the new president found the economy "sick" in production, distribution and regulation soon after his inauguration in August 1997. Despite declaring the state of the economy to be his administration's number one preoccupation, it took him fully a year to come up with an Economic Rehabilitation Program (ERP). The ERP catalogued Iran's familiar economic ills, with some proposed courses of action that were hardly innovative or effective.[6] A continuous fall in crude oil prices after mid-1997 and the precipitous decline in Iran's other foreign exchange sources made the program still-born; it was unceremoniously buried. A series of other external events led to a second external payment arrears and another set of new bilateral rescheduling. The oil bust also resulted in reduced industrial capacity utilization, massive workers' layoffs, and a decline in value of the Iranian *rial* in the free market.

By the planners' own admission, less than 65 percent of the plan's quantitative objectives were reached. Annual GDP growth at 3.8 percent was only 74 percent of the planned target, and except for the service sector, none of the other sectors reached its planned level. Unemployment averaged 14.5 percent a year, as less than half the 600,000 jobs planned for each year were created. The consumer price index rose by 25 percent a year instead of the projected 12.5 percent. Non-oil exports, instead of rising 8.4 percent a year, actually declined by 6.5 percent. Foreign exchange reserves were down to only about three months of imports. External debt rose to 15.7 percent of GDP. In addition to missing all of its quantitative targets, the plan was also remiss in achieving many of its qualitative goals.

Some modest achievements compensated for these negative developments, however. The rate of population growth was substantially reduced, thanks partly to the government's desperate last-minute efforts, but also as a result of increasing economic hardships—including rising youth unemployment, falling real salaries, skyrocketing housing costs—that required postponements of marriage and child bearing. Prices of some highly subsidized public utilities were modestly raised toward their true costs. The treasury managed to receive a sovereign rating of B2 from Moody's Investors Services, and the Central Bank succeeded in obtaining fresh credit from foreign private banks after a series of embarrassing forced rescheduling of previous arrears. With an interval of close to seven years, the World Bank resumed its lending to Iran for sanitation projects. Several oil and gas agreements on a buy-back basis were also concluded with non-American companies to raise Iran's energy production capacity. In 1999, the United States reduced some trade sanctions.[7]

The fourth phase, called *competition-oriented economic development*, covered the Third Plan (2000-2005), and was once again one of reform and liberalization.[8] While the objectives of this plan were more realistic and rational than those of the previous two, they still reflected the same familiar populist clichés embedded in the country's Constitution, and the commitments promised under the original structural adjustment program. Accordingly, social justice, a code phrase for controlled prices and broad subsidies, was to be combined with progress, which is a code word

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[6] For the content of the ERP see Jahangir Amuzegar, "Khatami and Iranian Economic Policy at Mid-Term," *The Middle East Journal,* Autumn, 1999.
[7] See Jahangir Amuzegar, "Iran's Post-Revolution Planning: The Second Try," *Middle East Policy*, March 2001.
[8] See President Khatami's report on the Third Plan to the Majles, *Hamshahri,* November 2, 2004.

for rapid growth, high employment, and pro-market reforms. True to form, the Third Plan also included quantitative targets for annual GDP growth, aggregate investment, public and private consumption, size of the national budget, banking system liquidity, consumer price increases, employment level, imports and exports, and foreign debt ceiling. For each of these categories, there were further breakdowns into sub-targets in minute decimal numbers. A novel feature of the plan, however, was the establishment of an Oil Stabilization Fund to safeguard future annual budgets against volatile oil price fluctuations. Under the OSF provisions, annual oil export revenues in excess of the budgeted amount had to be deposited in the Fund to be drawn upon during oil price slump and budget shortfalls. Part of the deposits could also be lent to private entrepreneurs for domestic investment subject to specific conditions.

The country's economic fortune fared somewhat better under the Third Plan, thanks mainly to new and unexpected oil windfalls, good weather conditions, and some economic reforms. Average annual GDP growth reached 5.4 percent. The official unemployment rate averaged 12.5 percent for the period— 30 percent below the planned target.[9] The official inflation rate, helped by massive subsidies, averaged 14 percent a year, while rises in liquidity at nearly 29 percent a year overshot the target by 66 percent. Total increase in national productivity at 0.52 percent a year lagged behind the projection of 0.86 percent. The population living below absolute and relative poverty lines is claimed to have declined.[10] Foreign reserves exceeded $34 billion thanks to continued annual surpluses in the current account. The Central Bank was successful in floating two fully-subscribed foreign exchange government bonds totaling 625 million euros. With the average price of Iranian oil ranging between $21 and $44 per barrel, monetary and fiscal policies were eased, and private investments surpassed the planned target.

By far the most significant reform achieved in the course of the Third Plan, however, was the final unification of the exchange rate in March 2002, placing the "floating" value of the Iranian *rial* on a basket of currencies. Exchange reforms also included acceptance of the obligations of the International Monetary Fund's Article VIII, eliminating most foreign exchange restrictions on current transactions for the first time since Iran joined the Fund in 1945. As part of a new trade liberalization drive, most export restrictions were eliminated. Non-tariff barriers were replaced by a better-structured and simpler tariff regime. Import licensing procedures were streamlined. The decades-old law for the attraction of foreign investment was revised in 2002 with a clearer legal framework and more attractive incentives. In the monetary and financial area, both the Treasury and the Central Bank were authorized to issue debt certificates—called Participation Papers—to cover the budget deficit and mop up excess liquidity in the market. State banks were given greater flexibility to set rates for both deposits and loans. Several private banks and insurance companies were licensed for the first time since the Revolution, and legislatively mandated credits to various sectors were reduced. New legislation regarding capital markets, electronic commerce, money laundering, checking transactions, and stock exchange operations were proposed to the *Majles*. Fiscal reforms, in addition to the establishment of the Oil Stabilization Fund, included the significant reduction of corporate and individual income tax rates, and the consolidation of scores of different fees and levies on various goods and services into a single new transaction tax.

On the flip side, the budget to GDP ratio turned negative with the shortfall equal to 3 percent of GDP; the non-oil fiscal deficit rose from 13.5 percent of GDP to 18 percent during the period.

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[9] For the authenticity and veracity of official employment figures see Jahangir Amuzegar, "Iran's Unemployment Crisis," *Middle East Economic Survey*, October 2, 2004.

[10] Statistics on poverty are the least reliable and most varied among Iran's economic data and not independently verifiable.

The nominal exchange rate—*rials* per US dollar—rose from about 6000 to nearly 9000. Public external debt increased from $8 billion to $15.7 billion—with "potential" liabilities reaching $33 billion. Privatization of state enterprises fell far short of the target.[11] The government's debt to the Central Bank reached an all time high at Rls 112 trillion—double the amount in 2001. And the OSF that was supposed to be drawn upon if oil revenue fell below target was used frequently to cover budget deficits—at a time when oil revenue exceeded the target in every single year.[12] Moreover, the three crucial promises regarding the replacement of then unfair subsidies by an effective safety net, conversion of then inefficient taxes into a value-added tax regime, and greater transparency in program budgeting still remained elusive goals.

The government's privatization efforts also were largely unsuccessful because the essential preconditions for such structural change—an open trading system, an effective regulatory framework, an active capital market, a competitive banking system, an impartial judiciary, and a predictable political environment for private investment—simply did not exist in Iran. Furthermore, the relatively fair economic record is marred by publicly acknowledged significant air and water pollution, considerable soil erosion, and alarming desertification and deforestation.[13] Added to these woes are the closely-related social scourges of endemic corruption, high divorce rates, widespread drug addiction, child labor, younger-age prostitution, violent urban crimes, and increased underground economic activities. [14] In sum, both the plan's quantitative and reform outcomes deviated from the targets by considerable margins—indicating once again the irrelevance of central planning to Iran's economic behavior and performance.

The Post-Revolution Report Card

An objective stock-taking of Iran's economic performance following the Revolution may be made in three different ways: first, measured by the two standard criteria of efficiency (Islamic "progress") and equity (Islamic "social justice")[15]; second, matched against the Islamic Republic's revolutionary promises; and third, compared with a similar period before the revolution. Lack of reliable data permits no more than a partial, and somewhat rudimentary, assessment of the results under all three methods.

The standard criteria are easiest to use. In terms of *efficiency*, official figures show that none of the universal indicators of development has behaved satisfactorily. Real GDP growth in the last 25 years has risen by an anemic 2 percent a year on average, somewhat below the 2.4 percent annual rise in population.[16] Per capita real GDP has declined by about 0.4 percent a year on average. Unemployment has been in the double-digit range during most of the post-revolution period—with yearly fluctuations between 9 and 16 percent. The consumer price index has

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[11] For problems involved in this policy see Jahangir Amuzegar, "Iran's Privatization Saga," *Middle East Economic Survey*, June 17, 2002.

[12] For a review of Iran's budgeting procedures see Jahangir Amuzegar, "Iran's Precarious Public Finance," *Middle East Economic Survey*, April 28, 2003.

[13] For a detailed evaluation of the plan, see Jahangir Amuzegar, "Iran's Third Plan: An Appraisal," *Middle East Policy*, Fall 2006.

[14] Cf. Jahangir Amuzegar, "Iran's Theocracy under Siege." *Middle East Policy*, Spring 2003.

[15] Efficiency normally refers to changes in such indicators as growth, employment, inflation, and both internal and external balance. By extension, it also includes environmental protection and nature's conservancy. Equity normally involves a fair distribution of income and wealth, equality of opportunities, absence of discrimination, and attention to gender-related issues.

[16] For a discussion of Washington's policy toward the Islamic Republic, see Jahangir Amuzegar, "Iran's Economy under the US Sanctions," *The Middle East Journal*, Spring 1997.

registered an annual rate of increase of about 20 percent during 1979-2005. The fiscal budget—officially "balanced"—has actually been in deficit because the Central Bank's financing of the gap has been treated as "income." Balance of external payments has also been mostly under pressure except during the recent oil boom.

This unenviable quantitative performance basically reflects the inherent growth-inhibiting features of the Iranian economy, including its outmoded, costly, and ineffective central planning exercise.[17] More significantly, Iran's modest economic growth rate of 4.7 percent a year since the end of the Iran-Iraq war has been due to high annual gross investments rather than from a more efficient use of resources. Iran's investment to GDP ratio has averaged about 19.5 percent a year during the period, matching those of high-growth Asian countries. Yet the GDP growth has been 50 percent lower due to the anemic trends in labor and capital productivity. Labor productivity during the 25-year period is estimated to have increased at about 1.5 percent a year, due mostly to the low level of workers' skills[18] and the mismatching of higher education curricula with the economy's job needs.[19] Capital productivity has also been low, at about a 2 percent increase a year on average due to the poor selection of investment projects, and the relatively long gestation period of such projects—estimated to be three times the global average. Iran's notably high capital-output ratio of 6.6 percent compares poorly with only about 4 percent among Asian tigers.[20]

Achievements in equity and social justice are harder to measure due to the lack of sufficiently reliable data on domestic income distribution, the shares of various social strata in free public services, the extent of poverty, and other social welfare indicators. Government officials claim that income distribution has not markedly changed since the Revolution, but this is hard to confirm since the annual decline in GDP per capita is unlikely to have affected all social strata uniformly. Furthermore, government data show that the bottom 10 percent of the population earn and consume only 2 percent of the national income, and the bottom 20 percent receive only 5.8 percent. By contrast, the top 10 percent enjoy 34 percent of the total, and the top 20 percent enjoy close to 50 percent. The estimated number of people below the national poverty line varies widely as cited by officials from the Management and Plan Organization, the Social Welfare Organization, and the Central Bank under various criteria, and with distinctions between absolute, relative, and "needy" categories. According to the latest statement by the director general of the Anti-Poverty Program of the Ministry of Welfare and Social Security, 2 percent of the rural and 4.5 percent of the urban populations live under the *absolute* poverty line.[21] Some 15 percent of the rural and 17 percent of the urban populations suffer from *relative* poverty. And 8 percent of the total is said to be living on charity.[22]

The second method of performance evaluation is a comparison between what the Islamic

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[17] It is interesting to note that even the government's shift toward the free market and its adoption of a privatization policy in the early 1990s had to be part of a central plan.

[18] A senior Ministry of Interior official claims that 77 percent of government employees lack higher education. See *Islamic Republic News Agency (IRNA)*, June 16, 2002.

[19] According to a top MPO officer, an average government worker produces only 4 hours and 14 minutes of productive work out of an 8-hour day job. See *Hamshahri*, October 16, 2004.

[20] According to a Sixth *Majles* deputy, only 10 percent of Iran's post-revolution airports offer any economic justification; in 30 percent of them, there is no daily activity; and in the rest, there is only one flight a day. See *Radio Azadi*, July 14, 2002. By an official estimate, most investment projects have taken 9 years to complete (as against the three-years standard).

[21] *Siasat-e Rooz*, (Tehran), July 21, 2005.

[22] See *Radio Free Europe/Radio Liberty*, October 28, 2002.

revolutionaries promised and what they have so far delivered.[23] The Shah's regime was faulted by the opposition, and particularly by the clerical elements within the rainbow coalition, for ignoring vital national interests. The Shah was chastised, in particular, for leading the nation toward the West's "crass materialism" and "consumerist culture," and anchoring Iran's survival and prosperity to foreign goods, technology, and managerial know-how. Agriculture was neglected, industry was anchored on assembly plant operation, and the banking system was oblivious to the needs of the poor. Oil export receipts were used to purchase sophisticated weapons, finance luxury imports, and encourage profligate consumption. All these practices were to have been reversed once the Islamic regime came to power. Economic planning would take place not for economic development alone, but also for social and cultural advancement. Agriculture would serve as the economy's pivot, and would eventually eliminate the nation's dependence on food imports. Industry would be freed from foreign dependence and assembly plant operation, and shifted toward reliance on domestic resources, and production for domestic needs. Foreign trade would be reconstructed with a view toward curtailing reliance on the West, and increasing relations with developing and Islamic countries. The banking system would be taken out of foreign tentacles, and run on Islamic interest-free principles. Foreign borrowing would be limited to a bare minimum. Foreign investments would be allowed if accompanied by transfers of technology. A frugal consumption model would be constructed to curb materialistic and consumerist instincts.

Despite these crowd-pleasing promises, evidence shows that none of the economic strategies and policies for which the Shah was taken to task has been fundamentally changed. And, none of the revolutionary promises has been faithfully delivered. Many have hardly been approached, and some have been totally discarded. Khomeini's exhortations regarding the virtues of spirituality, frugality, and disdain for material possessions have fallen on deaf ears. Even those initially devout followers openly ignore the Ayatollah's teachings. Clerical injunctions against crass materialism, wealth accumulation, profit making, and greed have become a matter of derision now. President Khatami's turbaned minister of information has gone as far as lecturing the managers of a *bonyad* responsible for the welfare of the poor that "creation of wealth" should be regarded as "sacred" a duty for the regime as the protection of liberty and provision of justice, in fact, was even more important than the other two because other goals cannot be properly achieved without wealth.[24] Stories about glaring extravagance by the so-called "millionaire mullahs" and their offspring are routinely reported in the daily press. Similar reports about hoardings and speculations, money lending at exorbitant interest rates charged in the *bazaar*, rent-seeking activities by people with access to the clerical power centers, special sweetheart deals among related office-holders, and blatant corruption fill the pages of even self-censored publications.[25] Supreme Leader Ali Khamenei has defined Iran's current woes as "poverty, discrimination, and corruption."

Economic self-reliance and self-sufficiency, which the leaders of the Revolution regarded as a *sine-qua-non* of political independence, also fell by the wayside. In presenting his 1999 budget to the *Majles,* President Khatami emphasized that no economy can develop without expansion of trade with the outside world, and that economic growth, high investment, and full employment are all dependent on foreign trade. In the last ten years, the regime applied for membership in the

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[23] For a more detailed discussion of this subject see Jahangir Amuzegar, "Iran's Economy before and after the Revolution," *The Middle East Journal*, Summer, 1992.
[24] *Hamshahri*, October 10, 2001.
[25] In *Transparency International*'s 2004 annual global corruption report, the Islamic Republic receives a rank of 88 out of 146 countries—9 places worse than its ranking of 78 in 2003. On a scale of 0 to 10, with a country enjoying 10 points as the least corrupt, Iran received less than 5.

World Trade Organization a total of 22 times—only to be rebuffed, due to the absence of consensus among members. The six million barrels a day of oil production during the mid-1970s that was condemned by the anti-Shah groups as a betrayal of future generations' interest is now the most coveted goal of the regime and the topmost investment priority in its "20-Year Economic Perspective."

Agriculture has never become the development's pivot as promised, but actually remains the domestic investors' orphan, due to high production costs and government-controlled farm prices. The recently celebrated self-sufficiency in wheat has been achieved at three times the average global cost per bushel and at the expense of cotton, oats, fruits, vegetables, and other cash crops where Iran has clear comparative advantages. Near self-sufficiency in red meat and milk has been reached as a result of sharp drops in demand due to their unaffordable prices for most wage earners. Non-oil exports that were considered badly neglected before have increased in current dollar terms thanks to a number of government support measures and exchange rate guarantees. Nevertheless, once adjusted for inflation and stripped of their import contents, they still compare unfavorably with pre-revolution figures both as a percentage of the national product, and certainly in per capita terms. Ironically enough, despite possessing 10 percent of the world's discovered oil and 15 percent of its natural gas reserves, the Islamic Republic is still a net importer of both gasoline and electricity—with annual payments for imported gasoline gobbling up nearly half of all receipts from non-energy exports.[26] Assembly-plant operation of the Shah's period, which was denounced as a wrong-headed industrialization policy and a waste of precious oil income, is now several times as prevalent as before not only in automobile manufacturing but in a host of other consumer durable items. National expenditures on armaments and nuclear power, which were once denounced as profligate and wasteful, are now being expanded both openly and discreetly in defiance of the plea by the world community.

In the financial sector, nationalized domestic and joint-venture banks have performed as the GDP's most laggard sub-sector due to their inefficiency, poor investments, and non-performing loans.[27] Foreign borrowing that had to be limited to absolutely dire needs is now the standard financing practice in the form of government bond issues and import finance. Public energy and other large-scale projects have been routinely financed through foreign credits; buy-back deals, and build-operate-transfer arrangements. Foreign direct investment that had to be shunned at all costs is now highest on the list of the regime's major foreign economic policy objectives. The Tehran Stock Exchange, which had been closed for more than ten years as the most conspicuous symbol of capitalism, has now been revived with great fanfare, and used as a major vehicle for privatizing state enterprises. And to top it all, Articles 43 and 44 of Iran's constitution—which had left the "commanding heights" of the economy in state hands—were rescinded by the Expediency Council in October 2004, enabling all major industries and basic economic activities (except for oil and gas) to be owned and operated by the private sector under certain conditions.

The third evaluation approach—a comparison with the past—would also turn in the Islamic regime's disfavor. During the 1960-1976 period, Iran enjoyed one of the fastest growth rates in the world—an average annual rate of 9.8 percent—and a rise in per capita income of 7 percent—resulting in a five-fold expansion of GDP.[28] By contrast, the GDP per capita figure in 2003 was still nearly 14 percent below that of 1976.[29] The unemployment rate, a mere 2.9 percent in 1976,

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[26] *IRNA*, May 9, 2005.

[27] For a fuller discussion of the subject see Jahangir Amuzegar, "Iran's New Banking Direction," *Middle East Economic Survey*, February 18, 2002.

[28] See *Islamic Republic of Iran—Selected Issues* (Washington: IMF, August 30, 2004).

[29] See *World Development Report 2005* (Washington: The World Bank, 2004); and *Human Development*

rose to double digits in the post-revolution era. The consumer price index that averaged a 5.7 percent increase a year from 1960-1976 registered an annual rate increase of about 20 percent in 1979-2005. Altogether, despite official efforts to magnify positive achievements, and equally strenuous spins to downplay glaring setbacks, the consensus among non-partisan observers is that Iran's economy is now in many ways worse than it was before the revolution. Based on the government's own statistics, almost all common indicators of economic progress lag behind pre-revolution figures. State dominance over the economy is more obtrusive. Dependence on oil exports is greater, economic growth is lower, and inflation is higher. Unemployment and underemployment are more widespread, and the income gap among households is wider. The government is in astronomically deeper debt to the Central Bank. External debt has markedly increased, with actual external debt at least 50 percent higher, despite an average annual oil income receipt of $18.8 billion during 1980-2005, compared to $7.7 billion during 1960-1980. Finally, the public's broader "misery index" (a combination of inflation, unemployment, and low consumer confidence) is at an all-time high.

The Underlying Fault Lines

In the last quarter-century, the Islamic Republic has shown an extraordinary instinct for survival and an astounding resilience against adversities. Despite the loss of many of its top leaders at the hands of domestic opposition groups, a long, bloody and disastrous war with Iraq, ethnic separatist insurrections, international sanctions, a burgeoning population, and frequent natural disasters, the clerical establishment has managed to stay in power. Why then has it produced such an unenviable economic record? Why does the economy still remain a bleak spot in its 25-year history, and a potential threat to its long-term survival? Why were economic issues the deciding factor in the result of the 2005 presidential election?

In light of the foregoing discussions, the precarious state of Iran's economy and the root causes of its shortfalls may be found in a vulnerable structure built upon hazardous fault lines. The current Iranian economy may be described as state-dominated, oil-dependent, inward-oriented, excessively controlled, under-taxed, over-subsidized, insufficiently competitive, and glaringly inequitable. Each one of these characteristics is individually and jointly responsible for the country's economic malaise.

First, state dominance over the economy is paramount. The multitude of bureaucratic agencies, state-owned enterprises, and state-charted entities providing public services make it difficult to determine the true share of the state in the formal economy. The country's comprehensive annual budget in recent years has hovered around 60 percent of GDP—up from less than 35 percent before the revolution. If the vast operations of the *bonyads* and their affiliated conglomerates were added to those of the public sector proper, the total might exceed 70 percent.[30] The government owns and operates all major industries (led by oil and gas), public utilities, banking, insurance, transport and communications, agribusinesses, and certain trade and services under an archaic, costly, and ineffective central planning system. Some 25 percent of the total labor force is employed in the public sector. Sharp increases in public sector employment are another clear indicator of the state's dominance. While Iran's population has nearly doubled between 1979 and 2005, government employment has quadrupled, and the total number of public sector employees has reached 4.2 million. The number of publicly owned large corporations has increased four

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Report 2004 (New York: UNDP, 2004).

[30] A Tehran publication claims the ratio of the comprehensive budget to GDP in 2004/05 to be 90.1 percent. See *Iran Economics*, May 2005.

times—with their aggregate annual budgets increasing 45-fold since 1980. Interestingly enough, even after the adoption of privatization as an official policy in the early 1990s, the number of major state enterprises has increased from less than 270 to more than 560—with only 294 reportedly making a profit. A recent report by the Management and Plan Organization lists eleven specific factors for the rise of the government's size.[31]

Second, petroleum is Iran's economic lifeblood, and the state-dominated economy is heavily dependent on oil exports. While the oil sector's share of GDP has remained less than 20 percent in recent years, crude oil exports continue to be the mainstay of Iran's economy. Revenues from petroleum sales provide about four-fifths of the country's total annual foreign exchange receipts. During the Third Plan, more than 64 percent of annual government revenue came from oil income, and upward of 75 percent of the budget was directly or indirectly tied to energy earnings.[32] More significantly, as world oil prices go, so goes the fate of the economy. The six distinct economic cycles of stagnation-recession and renewal-recovery in the last 25 years have been invariably linked to oil bust and boom. The recessions of 1979-81, 1986-89, and 1993-1999 can be traced to periods of global oil price slumps. By contrast, the economically vibrant years of 1982-85, 1990-92, and 2000-05 correspond with periods of high world oil prices. Nor is this correlation hard to detect. Oil booms increase the treasury's receipts, reduce budget deficits, expand public investment, finance the industry's needs for raw material and semi-processed imports, enable the government to import large volumes of consumer goods to curb inflation, and help the state banks pay back their external debt. An oil bust operates in a reverse manner by depressing all those factors.

Third, inward orientation is another major feature of Iran's economy. This isolationist posture goes back to a misconceived revolutionary emphasis on economic self-sufficiency as a symbol of political independence. Thus, while Iran has about one percent of the world population and seven percent of world resources, its current registered exports amount to only about four-tenths of one percent of world trade.[33] Despite recent trade liberalizations, Iran's average tariff rate in 2002—30 percent—was the 11th highest out of 193 countries surveyed by the IMF. In a 2004 survey, Iran was designated as the world's 8th most closed economy (ranked 148th among 155 countries in terms of non-interference)—with a ranking on a scale of 0 to 5, with 5 as the least open, of 4.16).[34] In OECD's 2004 global classification, Iran is listed as a country with the highest risks for foreign business involvement. The UNCTAD's 2004 annual report shows that in 2003 Iran ranked 124th among 196 countries in attracting foreign direct funds.

Widespread government regulations represent the fourth distinguishing feature of the Iranian economy. From the registration and licensing of business enterprises to wage/price decisions, labor relations, banking operation, trade practices, and capital flows, Big Brother's hand is conspicuous. A 2004 report by the World Bank concludes that the level of bureaucratic complexity involved in starting a business in Iran, on a scale of 0 to 90 (with 90 being the highest), is adjudged to be 67.[35] The latest annual report by the Heritage Foundation measuring ten factors affecting the extent of government interference in the economy (e.g., wage/price controls, foreign exchange regulations, trade barriers, and overall government interventions)

[31] *Hamshahri*, July 19, 2005.

[32] In the first three months of 1384 (2005/06), nearly 78 percent of the budget was financed by oil receipts. See *Hamshahri*, July 23, 2005.

[33] See *Trade and Development Report, 2005*, (Geneva: UNCTAD, 2005).

[34] *Index of Economic Freedom* (Washington: The Heritage Foundation, 2005).

[35] *Doing Business Indicators* (Washington: the World Bank, 2004)

regards the Islamic Republic as a most-regulated economy with the rank of 148 among 155 countries (in terms of non-interference).[36]

The fifth distinctive characteristic of the Iranian economy is its relatively low level of taxation. The Islamic Republic is one of the three countries (among 120 evaluated in the world) with the lowest ratio of tax to total government revenue. Taxes generate only about 25 percent of state revenue and less than 6 percent of nominal GDP, which is far below the planners' aspirations. Tax exemptions are extensive, as some 40 different entities engaged in trade and business are legally or effectively tax-free. Altogether, according to the government's top tax administrator, some 50 percent of Iran's GDP currently is exempt from all taxes.

Excessive subsidies constitute the sixth identifying feature of Iran's economy. These include explicit subsidies covering a range of essential goods and services that apply to all households regardless of income. Explicit subsidies to business firms include certain raw materials or equipment used by industry. Implicit subsidies cover mostly energy products (particularly gasoline, gas oil, and electric power). Explicit subsidies amount to about $6.5 billion, or nearly 5 percent of GDP, in 2004—up from less than one-tenth of 1 percent in 1979. Implicit subsidies are estimated to be about $14 billion, or some 12 percent of total national product.[37] By far the most objectionable aspect of these subsidies is their unfairness. By the World Bank's estimates, the richest ten percent of consumers benefit from subsidies on gasoline, medicine and bread many times more than the poorest ten percent. Furthermore, these subsidies, in addition to imposing an unbearable burden on the treasury's meager resources, have encouraged wasteful use, smuggling, and underground transactions.

Finally, the Iranian economy is insufficiently competitive in the global markets. Agriculture is totally rain-dependent and high-cost with respect to several main staples. Industry thrives mostly on imports of raw materials and processed goods. Services are small-scale and poorly run. And oil, in addition to being a non-labor-intensive industry, has its fortune determined by volatile oil prices in an undependable world petroleum market. Furthermore, production suffers from low productivity of capital and labor, and the lack of indigenous technology. Several thousand public corporations with privileged access to low-cost bank credit, government subsidies, and import protection are over-staffed, poorly managed, and closed to public scrutiny. By some private estimates, one half of public servants and one third of workers in public corporations are redundant. Still further, domestic markets are controlled by numerous private and public monopolies. The business playing field in Iran is not only slanted but also unlit. The priority given to Islamic and revolutionary commitments as selection criteria for managerial cadres has deprived the country of needed professional expertise and competence. Management incompetence and the absence of transparency in public enterprises are aggravated by widespread and institutionalized corruption—an issue most prominently raised by all seven candidates in the 2005 presidential election. Transparency International's 2004 report on global corruption places Iran at 88 in a roster of 146 countries—10 places points lower than in 2003.

An Ill-Served Generation

The banners under which the anti-Shah revolutionary victors established the new regime consisted of three principal slogans: independence, freedom, and the Islamic Republic. Twenty-six years later, the first post-revolution generation, however, does not enjoy real political

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36 See *Index of Economic Freedom* (Washington, D.C.; The Heritage Foundation, 2004).

37 For a detailed discussion of these subsidies, see *Iran: Medium-Term Framework for Transition* (Washington: The World Bank, April 30, 2003), Ch. 9 and Appendix 5.

democracy, economic security, Islamic social justice, or even the minimum freedoms guaranteed by the Islamic constitution. Moving from one crisis to another, the economy has suffered from high opportunity costs of flawed investment projects, colossal waste and inefficiency in public operations, inexcusable blunders in major domestic and foreign policy decisions, endemic corruption in business deals, and the intellectual hollowing of the country through an unchecked brain drain. Between 1995 and 2004, Iran's HDI rank in the annual Human Development Report was lowered from 70 to 101, among 174 countries.[38] Thus, after years of promising to come up with an "Islamic economic paradigm" to serve as a guide for the whole Islamic world, the country's conservative leaders have from time to time talked about adopting "the Chinese model." That is tantamount to asking Mao's atheist regime to come to the aid of Iran's Islamic theocracy.[39] In short, the nirvana that the post-1979 generation was soon to enjoy has turned out more and more to resemble Dante's *Inferno*.[40]

Early Prospects

With the victory of Ahmadinejad in the June 2006 presidential election, the outlook for the Iranian economy has become more than ever precarious and uncertain. A self-proclaimed religious fundamentalist dedicated to Ayatollah Khomeini's ideals of individual piety and social justice, the new president has already raised the specter of a return to the early days of the 1979 revolution. Visibly troubled by his co-religionists' penchant towards the "Chinese model," he has pledged once again to turn Iran into a role model of a modern, progressive, and powerful Islamic society. His post-election statements regarding the necessity of thinking outside the box presages new state intervention and regulation. His open advocacy of redistributing Iran's wealth among the poor, increasing budget subsidies, lowering interest rates, raising government salaries, reexamining energy buy-back agreements, ending the reign of the "oil mafia", and giving domestic entities priority over foreign oil and gas companies sound ominous.

Iran's deeply-rooted economic problems of relative stagnation, protracted unemployment, stubborn double-digit inflation, perennial budget deficits, widespread poverty and widening income gaps, low overall productivity, and a harmful mixture of crony capitalism and crude socialism require some serious, no-nonsense undertakings, such as vastly larger annual real net investment, greater technical know-how, and more competent management. None of these are yet to be seen in Ahmadinejad's radar. Furthermore, should he succeed in putting his populist ideas into law with the help of a complacent *Majles* and a supportive Council of Guardians, one should expect that all the economic reforms of the past fifteen years would be reversed, and Musavi's disastrous agenda would be resuscitated. And, if his promises do not go beyond campaign rhetoric, it will still take some time for investors' confidence to be restored. Already reports of capital flight and an accelerated brain drain fill the front pages of the local press. Moreover, the new president's chauvinistic pronouncements about Iran's right to enjoy nuclear power status may jeopardize Iran's chances of concluding a favorable trade and cooperation agreement with the European Union and joining the World Trade Organization.

The one single silver lining in this disturbing perspective is the exigency of time. That is, the same thorny economic problems that catapulted Ahmadinejad from being an obscure governor

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[38] For the definition and methods of calculation of these indices see the technical notes in the original source.

[39] Cf. Jahangir Amuzegar, "Iran's Prospects under the 7th Majles," *Middle East Economic Survey*, February 23,2004

[40] See Jahangir Amuzegar, "Khatami: National Hero in Search of Relevance," *Middle East Policy*, Summer 2004.

and a fanatic mayor to occupying Iran's highest office and becoming a potential savior could be compelling enough to box him in. At no time in world economic history has "distribution before growth" effectively solved the problem of mass poverty. There is no reason to believe that it can now in the Islamic Republic. Robin Hood did not hurt the rich as much as he ruined the chances of the poor to grow out of poverty. Should Mr. Ahmadinejad ignore this historical imperative, the rude awakening may not wait until the end of his term.