

## Concept

# The Iranian Economy

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### Definition

The Concept 'The Iranian Economy' refers to the main characteristics of Iran's current economic situation, its major institutions and the political trends affecting it.

### Principles of the Economy

The Constitution of the Islamic Republic of Iran stresses two key principles:<sup>1</sup>

- **Islamic Justice** – Islamic law and tradition promote the provision of basic necessities, employment and leisure to all people, and forbids risk-taking and wealth aggrandizement. According to this approach, growth is not the highest priority.<sup>2</sup>
- **Self-sufficiency** – In order to ensure the 'independence' of the national economy, foreign ownership is strictly curtailed.

These principles manifest themselves in a government controlled economy divided between the state-owned and cooperative sectors. The state-owned sector assures independence and the cooperative sector distributes goods and services in accordance with the tenets of Islamic Justice.<sup>3</sup>

### Major Players in Iranian Economy

The Iranian economy is dominated by the state. Private production is absent, and private investment is substantially limited.<sup>4</sup>

Three major players dominate Iran's economy:

1. **State-Owned Industry** – Estimates vary, but up to 60%<sup>5</sup> of Iran's production, including all large industries, is in state hands.<sup>6</sup> State-owned firms are charged with meeting production targets set by the Majlis (the Iranian parliament).<sup>7</sup>
2. **Bonyads**<sup>8</sup> or Islamic charities are the cooperative sector of the Iranian economy. They control a substantial portion of the non-oil economy,<sup>9</sup> and are considered to be largely inefficient.<sup>10</sup>

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<sup>1</sup> [The Constitution of the Islamic Republic of Iran](#), Article 43.

<sup>2</sup> Islamic economics stresses three points: all economic activity must conform to divine commandments, cooperation between market participants is encouraged, and a sense of universal brotherhood among Muslims is encouraged. The chief differences with market economies are prohibition of interest and risk taking. The former affects all forms of consumer and commercial finance, the latter results in an absence of options and futures in Islamic capital markets. (J. Barkley Rosser, Jr. and M. Rosser, **Comparative Economics in a Transforming World Economy**, The MIT Press, Cambridge, MA: 2004).

<sup>3</sup> [The Constitution of the Islamic Republic of Iran](#), Article 44.

<sup>4</sup> Preferential financing and regulatory structures substantially limit private investment in production and manufacturing. See: **EIU Country Report: Iran**, 2006 – "Interest charged on loans can amount to as much as 30% a year for private-sector customers" (Dr. Abbas Bakhtiar, "[Ahmadinejad's Achilles Heel: The Iranian Economy](#)", **The Iranian**, 1/25/07).

<sup>5</sup> **EIU Country Report: Iran**, 2006

<sup>6</sup> [The Constitution of the Islamic Republic of Iran](#), Article 44.

<sup>7</sup> **EIU Country Report: Iran**, 2006.

They receive government subsidies and tax benefits, and answer directly to Iran's Supreme Leader.

3. The **Bazaar** is responsible for import, export and retail trade within Iran. The bazaaris wield considerable influence over economic policy.<sup>11</sup> However, their market share is thought to have fallen as industrialists and financiers in the state-owned sector have usurped many traditional import/export channels.<sup>12</sup>

## Characteristics of Iranian Political Economy

### Economic Policy Guarantees Political Stability

Iran's economic policy is designed to ensure the stability of the current political regime. Growth is sacrificed to ensure the major players' interest in maintaining political stability. Specific policies include:

- **Preferential treatment** – The Government provides preferential access to credit, subsidies, exchange, licenses, and contracts to the state-owned industries,<sup>13</sup> to the Bonyads<sup>14</sup> and to its loyalists.<sup>15</sup>
- **Populist policies** – Subsidized consumer products, especially gasoline, ensure popular dependence on regime stability.<sup>16</sup>
- **Economic diplomacy** – Iran supports joint-ventures of dubious economic value with allies to strengthen political ties.<sup>17</sup>

### Limited Productive Capacity

The combination of natural resource wealth, demand for upstream products, and constitutionally mandated self-sufficiency has created a **diversified economy**. Iran maintains domestic weapons,

<sup>8</sup> The Bonyads were established directly after the Islamic Revolution and are enshrined in the Iranian Constitution. They grant significant authority to the clerical establishment without fear of government oversight. (Ali Saeidi, "[The accountability of para-governmental organizations \(bonyads\): the case of Iranian foundations](#)", **Iranian Studies**, Vol. 37, Issue 3, September 2004), [The Constitution of the Islamic Republic of Iran](#), Article 44.

<sup>9</sup> Official data is lacking. While experts agree that the Bonyad contribution is large, there is no agreement on the total size of the sector. Bakhtiar claims that the Bonyads control nearly 30% of the Iranian economy. Karbassian places it at 11% of GDP. (Dr. Abbas Bakhtiar, "[Ahmadinejad's Achilles Heel: The Iranian Economy](#)", **The Iranian**, January 1, 2007 and A. Karbassian, "[Islamic Revolution of the Management of the Iranian Economy](#)", **Social Research**, Summer 2007).

<sup>10</sup> In 1999, it was estimated that only 21% of the firms under the control of the largest and most powerful bonyad were profitable. ("[Textile workers fight against privatization](#)", **IranReporter.com**, 6/20/01).

<sup>11</sup> **EIU Country Report: Iran, 2006** – The bazaaris were instrumental in toppling the Shah and instating to current regime during the Islamic Revolution.

<sup>12</sup> Angus McDowall, "[Iran versus the West: the view from the Tehran bazaar](#)", **The Belfast Telegraph**, 2/16/07.

<sup>13</sup> **EIU Country Report: Iran, 2006** – To achieve production targets the government provides public firms with below market interest rates on credit.

<sup>14</sup> Dr. Abbas Bakhtiar, "[Ahmadinejad's Achilles Heel: The Iranian Economy](#)", **The Iranian**, 1/25/07.

<sup>15</sup> Wealthy and powerful bazaaris are nominated to lead the country's bonyads by the Supreme Leader, ensuring their loyalty to the regime. (Robert D. Kaplan, [A Bazaari's World](#), March, 1996, **The Atlantic**); Mid-level traders are given preferential treatment depending on their closeness to the political structure (Alan Richards, "[The Political Economy of Economic Reform in the Middle East: The Challenge to Governance](#)", Oct. 2001, Prepared for RAND Project "The Future of Middle East Security").

<sup>16</sup> Atta Tarki, "[Iranian Energy Subsidies](#)", **Captus**.

<sup>17</sup> Iran has inked deals to build cars in Syria and to import gasoline from Venezuela ("[Joint Iran-Syria Car Producing Plant Opens in Syria](#)", **IRNA**, 3/8/07, "[Iran to Build Oil Refineries in Venezuela](#)", **IRNA**, 6/1/06).

automobile, electronics, and nuclear industries among others. In addition, it produces agricultural goods, minerals and metals, and hydrocarbons.<sup>18</sup>

However, Iran's industrial base suffers from a **lack of investment in production**:

- In the state-run sector, funds are appropriated to achieve production targets, not to reward economic viability.<sup>19</sup>
- Private investment in most industries is prohibited by strict regulation and expensive credit deterrents would be entrepreneurs.<sup>20</sup>

Consequently, Iran's manufacturing sector is low in productivity and has low export potential.<sup>21</sup>

Therefore, the bulk of government revenue and export dollars are earned through **the sale of raw materials**, including metal ores, agricultural products, and especially oil.<sup>22</sup> The oil sector is the largest source of government revenue, one of its largest employers, and the country's dominant industry.

However, it should be noted that due to its low productivity and investment, extraction of raw materials is below potential.<sup>23</sup>

### **Dependence on Foreign Trade and Investment**

Iran's low productivity breeds a unique three-fold dependence on world markets:

1. **Dependence on oil export** – Political stability rests on Iran's ability to profitably sell oil. Government revenue and export earnings, based largely on sales of oil and other natural resources, fluctuate with world commodity prices. Japan, South Korea, Taiwan, and Western Europe have historically been Iran's chief export markets. China too has increased purchases of Iranian oil in recent years.<sup>24</sup>
2. **Dependence on foreign investment** – Iran requires FDI for oil and natural gas production.<sup>25</sup> Production has stagnated because Iran lacks the ability to develop its own fields,<sup>26</sup> threatening domestic spending and political stability.
3. **Dependence on foreign production and import** – Iran depends on foreign, capital-intensive imports for goods it can not produce, including: advanced weaponry from Russia<sup>27</sup> and

<sup>18</sup> **EIU Country Report: Iran, 2006** – Iran is the Middle East's largest steel producer and her agricultural base increasingly provides processed foods, rubber products, and paper products. Refining her natural oil wealth for domestic use has catalyzed the growth of the petro-chemicals sector.

<sup>19</sup> "[Banking System in Iran and the Need for Reform](#)", **Commercial Studies**, No. 147, Dec. 1999.

<sup>20</sup> "[Construction Sector Makes Recovery](#)", **Iran Daily**, 11/17/04. Lack of other alternatives for private investment has created a booming construction market.

<sup>21</sup> Amouzegar, "Khatami and the Iranian Economy at Midterm" **Middle East Journal**, 53, 4 (Autumn, 1999).

<sup>22</sup> **The CIA World Factbook** lists Iran's [chief exports](#). Its non-oil [mining industry](#) (IranYellowPages.net) is an important export industry, as are specialty agricultural products like pistachios and caviar.

<sup>23</sup> **EIU Country Report: Iran, 2006** – Iran's automobiles are low quality and have improved only with the introduction of foreign joint-ventures. Mining (see "[Mining to Iran](#)") and oil production are inhibited by lack of FDI. Despite the size of its reserves, Iran is a net importer of natural gas.

<sup>24</sup> [CIA World Factbook](#)

<sup>25</sup> For an example of the various aspects affecting Iran's ability to develop its Oil production through FDI see: Raquel Shaoul, "An Evaluation of Japan's Current Energy Policy in the Context of the Azadegan Oil Field Agreement signed in 2004," **Japanese Journal of Political Science**, Vol. 6 (3), 2005, pp. 1-27.

<sup>26</sup> Barry Schweid, "[Analysis says Iran's oil revenue is plummeting](#)", **Los Angeles Times**, 12/26/06. Stagnating oil revenues and increasing domestic demand pose a severe threat to Iran's export revenues.

<sup>27</sup> Lionel Beehner, "[Russia-Iran Arms Trade](#)", **The Council on Foreign Relations**, 11/1/06.

China,<sup>28</sup> capital equipment from Europe,<sup>29</sup> gasoline it cannot refine, and natural gas it cannot extract.<sup>30</sup>

## Macroeconomic Overview

Iran suffers from inflation,<sup>31</sup> unemployment,<sup>32</sup> and poverty.<sup>33</sup> The government compounds the problem with structural deficits.<sup>34</sup>

Despite these issues, Iran has grown at 5% annually since 2000 due to a rise in commodity prices. Structural changes, made possible by increased national income and decreased foreign debt, contributed to growth by stimulating private investment and capital purchases by industry.<sup>35</sup>

## The Economic Conversation

Three main trends prevail in the Iranian economic discourse:

- **Populism** – President Ahmedinejad and the Majlis are the chief protagonists of a policy that seeks to return the country's oil wealth to the poor masses. Specific policies include: expansion of government spending on social programs, privatization through 'justice shares',<sup>36</sup> and continued opposition to foreign ownership of state assets.<sup>37</sup>
- **Crony Capitalism** – Former President and Head of the Expediency Council<sup>38</sup> Rafsanjani and Supreme Leader Khamenei share a policy platform that calls for immediate privatization of the majority of state assets. It is suspected that the privatization scheme will shift control and ownership to Bonyads, citizens will receive 'justice shares' and the Tehran Stock Exchange will only offer a minority stake for investors. While nominal ownership may shift, political allies of the Supreme Leader will primarily benefit, and his direct control over the economy will increase.<sup>39</sup>

<sup>28</sup> ["US accuses China of weapons trade"](#), BBC, 1/15/04.

<sup>29</sup> [CIA World Factbook](#).

<sup>30</sup> ["Vicious Fuel Cycle"](#), Iran Daily, 12/16/04.

<sup>31</sup> **EIU Country Report: Iran**, 2006 – In 2005, consumer price inflation stood at 13%.

<sup>32</sup> Official unemployment rates hover around 12%, but the situation is thought to be worse than 25% amongst the young. "Stubborn, double-digit, unemployment is currently the Islamic Republic's most acute single economic concern." (Jahangir Amuzegar, ["Iran's Unemployment Crisis"](#), **Middle East Economic Survey**, VOL. XLVII, No. 41, 10/11/04.

<sup>33</sup> 21% of the population lived below the poverty line in 2001 (Hamid Zangeneh, ["Socioeconomic Trends in Iran: Successes and Failures"](#), **The Muslim World**, Volume 94, Number 4, Oct. 2004, pp. 481-493(13)).

<sup>34</sup> Roger Stern, ["Come On, Europe!"](#), **The International Herald Tribune**, 2/23/07. Despite record oil revenue, the Majlis has tapped the Oil Stabilization Fund, a reserve to be kept for years with weak oil prices, to fund domestic spending.

<sup>35</sup> **EIU Country Profile Iran**, 2006 – With the upturn in oil prices, the central bank used the opportunity to unify exchange rates and to rescind import restrictions.

<sup>36</sup> **EIU Country Report Iran**, 2006 – Ahmedinejad proposes to distribute subsidized shares in privatized national industry to all Iranian citizens. The policy is at odds with economic doctrine seeking to increase competition and stimulate productivity growth.

<sup>37</sup> **EIU Country Profile Iran**, 2006 – Despite a constitutional change that permits foreign ownership, the Majlis has stymied proposals for privatization and has also imposed difficult terms on foreign firms seeking to operate in Iran.

<sup>38</sup> [The Constitution of the Islamic Republic of Iran](#), Article 110 – The Expediency Council is charged with resolving disputes between the Majlis and the Guardian Council.

<sup>39</sup> Mehdi Khalaji, ["Iranian President Ahmadinezhad's Relations with Supreme Leader Khamenei"](#), **The Washington Institute**, 9/12/06.

- **Liberalism** – Former President Khatami and the Central Bank are the primary supporters of liberal economic reforms. Though they have managed modest privatization and exchange-rate reform, most policy proposals have been stymied.<sup>40</sup>

Currently, the economic conversation in Iran centers on the competition between the populist and crony capitalist models. The conversation focuses on control of state assets, not structural change. Market liberalism is not part of the conversation.<sup>41</sup>

Market reform threatens the structure of Iran's political economy. The clerical elite, which control the bonyads and state-owned industries, would be weakened by privatization that introduces competition and foreign investment. The population at large, mollified by extensive subsidies, would react against the regime should they be removed.

## Sanctions & Embargoes

Iran's access to flows of goods, services, and capital are limited by the US embargo and UN sanctions.

United States actions against Iran include:

- **A Total Trade and Investment Embargo** on all business with Iran by US based firms and citizens.<sup>42</sup>
- **Sanctions against Foreign Oil Firms** operating in the United States who have invested over \$20M in Iran's petroleum resources.<sup>43</sup>
- **Sanctions against Foreign Banks** investing in Iran. Transactions with Iran by US citizens at foreign banks, by foreign branches of US banks, and all dollar denominated transactions with Iran are forbidden.<sup>44</sup>

UN Sanctions against Iran target: (see: UN Security Council Resolutions 1737 and 1747)

- **Iran's nuclear and ballistic missile programs.** The sanctions aim to halt the supply of funds and equipment to Iran's nuclear and ballistic missile programs.<sup>45</sup>
- **Iran's Military involvement in the Middle East.** UNSCR 1747 bans Iranian arms exports, a key element of its support of proxies in Iraq and Lebanon.<sup>46</sup>

<sup>40</sup> EIU Country Report: Iran, 2006.

<sup>41</sup> Mehdi Khalaji, "[Iranian President Ahmadinezhad's Relations with Supreme Leader Khamenei](#)", **The Washington Institute**, 9/12/06.

<sup>42</sup> Since the Iranian hostage crisis, the US has imposed various unilateral sanctions on trade and investment in Iran by US firms and citizens. On May 6<sup>th</sup>, 1995, President Clinton issued Executive Order 12959 banning all trade and investment by US citizens or firms in Iran. ([Executive Order 12959](#), **The United States of America National Archives**, 5/6/95).

<sup>43</sup> These sanctions are codified in the Iran and Libya Sanctions Act of 1996. ([The Iran and Libya Sanctions Act of 1996](#), **The Congressional Record of the United States of America**, 6/18/96).

<sup>44</sup> [Overview of Sanctions](#), **United States Department of Treasury**, Lionel Beehner, "[U.S. Sanctions Biting Iran](#)", **The Council of Foreign Relations**, 1/23/07.

<sup>45</sup> [UNSCR 1737](#), **The United Nations Security Council**, 12/23/06 and [UNSCR 1747](#), **The United Nations Security Council**, 3/24/07. (Peter Beaumont and Robert Tait, "[UN sanctions hit Iran after call by Bush](#)", **The Observer**, 12/24/06).

<sup>46</sup> The resolution forbids Iranian arms exports and sanctions organizations tied to the Revolutionary Guards and Al Quds forces, known for their activity in Iraq, Lebanon, and the Palestinian Territories. (Thom Shanker, "[Security Council Votes to Tighten Iran Sanctions](#)", **The New York Times**, 3/24/07 and [UNSCR 1747](#), **The United Nations Security Council**, 3/24/07).

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