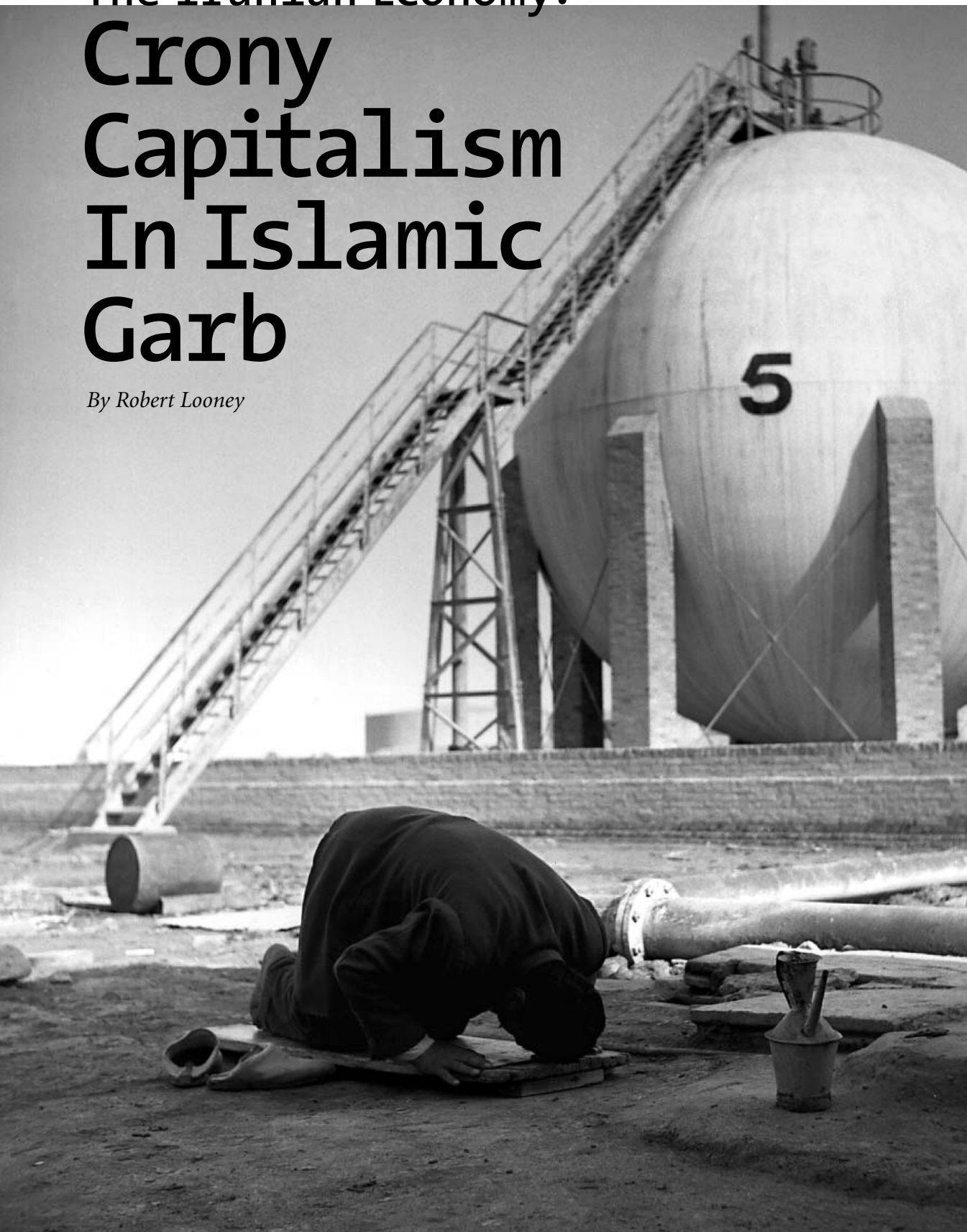
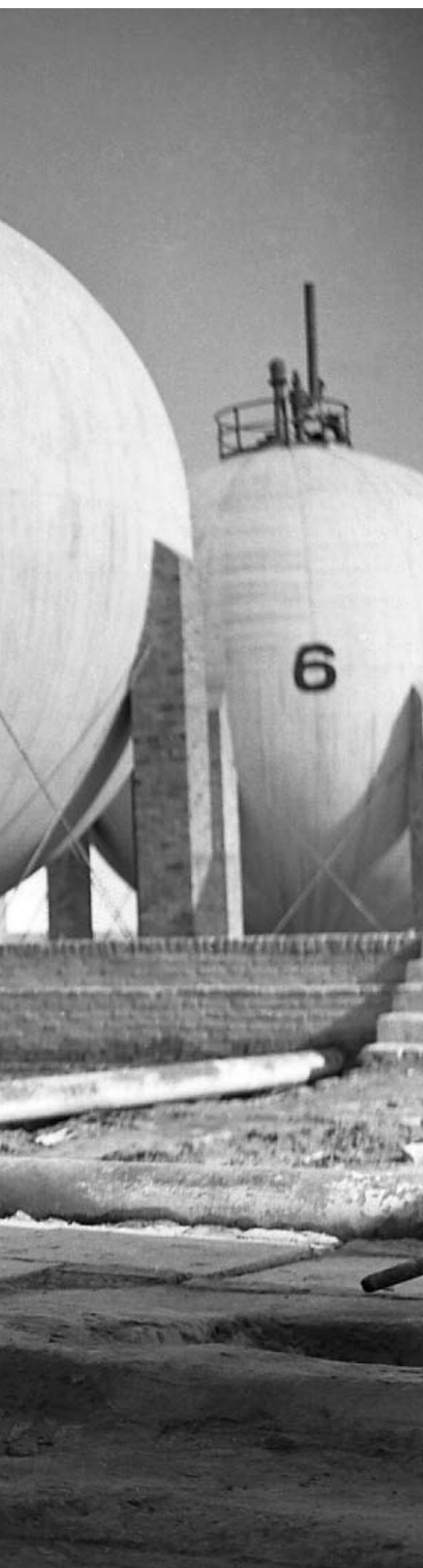


# The Iranian Economy: Crony Capitalism In Islamic Garb

*By Robert Looney*





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When asked what he was going to do about rising rates of inflation in the new Islamic Republic of Iran, Ayatollah Ruhollah Khomeini replied, “This revolution is not about the price of watermelons.”

The Ayatollah may have meant what he said. But the practical matter of capturing and consolidating power after a bloody revolution is, indeed, about the price of watermelons – not to mention bread and meat – as well as about access to education, housing, medical care and jobs. And it is hard to argue with cynics who conclude that all the Iranian revolution has really accomplished is the replacement of one parasitic elite, which owed allegiance to the Shah, with another, which claims legitimacy as the flagbearer of radical Shiite Islam.

The data on Iran’s economy paints a gloomy picture. While macroeconomic performance has improved in the past few years thanks to the dramatic increase in oil prices, the long-run pattern is one of decline.

At the time of the revolution in 1979, Iran had a GDP roughly equal to Spain’s, pumped one-tenth of the world’s oil, and nurtured a vibrant middle class. Today, per capita income is one-third that of Spain, oil production is down by 30 per cent, and the middle class is being squeezed by inflation, unemployment and stagnant wages.

Iran is facing many of the problems common to poor countries – most notably, a relatively young population made angry and restless by its grim economic prospects. Moreover, as in many other less-developed countries, dependence on natural-resource production wags the dog: oil revenues

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represent the bulk of both government income and foreign exchange earnings in Iran, and thus give the officials and bureaucrats who control the petroleum industry disproportionate influence over the economy and the political system.

It should not be surprising, then, that Iran faces a familiar (and formidable) barrier to

### IRAN BY THE NUMBERS

GDP at current exchange rate (2004)	\$154 billion
GDP per person, purchasing power parity (2004)	\$7,700
GDP growth rate (2004)	6.3 percent
Inflation rate (2004)	16 percent
Labor force (2004)	23 million
Labor force in agriculture (2001)	30 percent
Foreign direct investment (2003)	\$120 million
Exports of goods & services (2003, % of GDP)	24 percent
Oil production (2004)	3.9 million barrels/day
Domestic oil consumption (2004)	1.4 million barrels/day
Oil exports (2004)	2.5 million barrels/day
Proven oil reserves	131 billion barrels
Population (2005)	68 million
Population below poverty line (2002)	40 percent
Male literacy	86 percent
Female literacy	73 percent
Life expectancy at birth (2003)	69.4 years
Infant mortality (2004)	42 per 1,000

SOURCES: CIA World Factbook, World Bank

growth: changes that diversified and decentralized the economy would weaken the ruling elite, and are thus bound to be bitterly resisted. Indeed, while every multilateral organization is pressing Iran to liberalize the domestic economy and open it to external economic forces, the tide appears to be moving in the opposite direction. Conservatives, whose hold on Parliament was recently strengthened by gains in what amounted to a rigged election, seem determined to extend state control – not to loosen it.

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## MEASURING UNDERACHIEVEMENT

A variety of international comparisons suggests just how much Iran would have to change to join the crowd of rapidly growing middle-income economies.

**Globalization.** The Globalization Index, produced by *Foreign Policy* and the A.T. Kearney consulting firm, ranks 62 countries (accounting for 96 percent of world output) by a variety of factors. In 2005, Iran placed dead last, behind laggards like Nigeria, Egypt and Peru.

When the results are viewed by subcategory, a somewhat more textured picture emerges. While Iran ranks 61st in “political engagement” (membership and activity in international organizations) and 62nd in “personal contact” (international travel and communications, financial remittances), it does somewhat better in the economic arena. For example, the Islamic Republic ranked 47th in trade openness and 48th in foreign direct investment. Still, it is plain that the Iranian economy must slog on without most of the benefits of international economic integration.

**Governance.** World Bank researchers recently ranked 199 countries on the quality of governance, based on six categories: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption. By most of these criteria, Iran is in the bottom-quartile – and is not above average in any category. Moreover, between 1996 and 2002 the country lost ground in three categories – voice and accountability, political stability and government effectiveness. And it ranks in the bottom decile in regulatory quality, a critical factor in the development of an efficient market-based economy.

**Economic Freedom.** The Index of Economic Freedom, compiled by the Heritage Foun-



dation and the *Wall Street Journal*, scored Iran 148th out of 161 countries in 2005. Key problems include the abuse of individual property rights (especially when they clash with the interests of state-favored elites); the omnipresence of state-owned enterprises, which makes it difficult for private firms to compete; and the arcane rules of Islamic banking, which serve as a cover for noncompetitive lending practices.

**Access to Capital.** The Milken Institute's Capital Access Index weighs seven factors to gauge the ease with which productive enterprises gain access to financial capital. And here, too, Iran ranks near the bottom. In a sample of 121 countries, it was in 79th place in 2005, behind Mongolia and Uganda. Insight into the causes of Iran's low ranking can be found in the index's sub-rankings. Iran did especially poorly in the quality of the macroeconomic environment (93rd, below the Central African Republic and Honduras), the de-

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gree of intervention in bank-based business finance (87th), the availability of alternative financing like venture capital and credit card loans (104th, behind Burundi and Guinea) and access to international sources of finance (98th, behind Angola and Armenia).

#### **POST-REVOLUTION POLICYMAKING**

There have been distinct phases in economic policymaking since the fall of the Shah. The first radical phase, from 1979 to 1981, was

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highlighted by a wave of post-revolution nationalization and confiscation of property from individuals associated with the Shah's rule. The second radical phase, from 1982 to 1984, was marked by a shift from modern state socialism to strictly Islamic policies – notably, the imposition of interest-free banking and the dismantling of the Shah's brand of central planning.

The first pragmatic phase, from 1985 to 1989, was not marked by major changes in economic policy, but, instead, by modest opening to the West as part of a broad effort to cope with economic and military crises. The precipitating factor was the huge cost of the war with Iraq, as measured in both lives and money. Low oil prices exacerbated the economic problem.

The second pragmatic phase, from 1989 to 1997 (which coincided with Akbar Hashemi Rafsanjani's presidency), was marked by the introduction of five-year planning, some privatization of state enterprises, and more-determined attempts to create ties to the West. Pragmatism, however, had its limits. The government did not back away from efforts to impose Islamic rules on the domestic economy, and did not reduce support for fundamentalist Islamic movements aboard.

The social reform phase, from 1997 to 2004, began with the election of Mohammed Khatami as president in 1997. His policies, opposed by the conservative the Shiite legal establishment, emphasized due process in law and relaxation of controls over political discussion and social customs. Khatami sought an economic third way for Iran that would somehow combine modernization with adherence to Islamic law. He also continued Rafsanjani's halting efforts to open Iran to the world economy. These steps, proposed by the World Bank and IMF in the early 1990s, were

designed to diversify output, to discipline markets by opening them to foreign competition, and to reduce the role of the state in the economy. The package included:

**The harmonization of official and commercial exchange-rate regimes.** The Bank Markazi, Iran's Central Bank, now operates a "managed float" currency system, buying and selling foreign exchange in the global market. The Bank has the discretion to allow a modest depreciation of the Iranian rial in order to improve the competitiveness of non-oil exports – mostly petroleum-based chemicals and industrial goods. The medium-term goal was to allow the currency to float on its own.

**The adoption of a foreign investment law,** offering better protection for foreign investors and opening the entire industrial and services sectors to foreign direct investment. Most important, the law guarantees the right to repatriate both capital and profits.

**Progress in trade liberalization,** reflected in the reduction of non-tariff barriers (like quotas) and their replacement with tariffs, along with an easing of regulation on non-energy exporters.

**Key financial services fixes,** including the licensing of three private banks and insurance companies, and the recapitalization of the state-owned banks. Growth of private financial institutions should mean better access to credit for fledging entrepreneurs.

**Proposed fiscal changes,** including a plan to lower and simplify corporate and personal income taxes and to lower rates.

The current hard-line-conservative phase began in 2004 with the manipulation of Parliamentary elections, which created a radical Islamic majority and culminated in the election of an ultra-conservative president, Mahmoud Ahmadinejad, in the summer of 2005. It is not yet clear whether Ahmadinejad will attempt to fulfill his populist promises to cre-

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ate jobs and redistribute wealth. But even if he were to try, it is far from clear that he could deliver; the disenfranchised may have voted for him, but he could not have been elected without the blessing of the clerics, military officers and commercial interests who enjoy the fruits of government-as-usual.

What is the prospect for the creation of institutions capable of supporting a modern dynamic economy? The idea of adopting the ways of the West plainly offends the clerics. On a more fundamental level, change is not a priority because the conservatives believe that as long as oil revenues are buoyant, the existing system is capable of generating enough economic trickle-down to keep discontent at bay.

They are probably right. The Iranian reform movement has, to date, waxed and waned in counterpoint to economic growth. And growth has been closely tied to oil revenues. The boomlet in economic activity after the revolution coincided with a strong recovery in oil output. Similar peaks occurred from 1989 to 1991 and in 1996. The cycle is once again underway, following the rise in oil prices from 2000 to now.

#### **DIAGNOSIS OF THE ECONOMIC MALAISE**

Iran apparently suffers from what was once called “Dutch disease” (the Dutch have a lot of natural gas in the North Sea) and is now more commonly called the “resource curse.” Paradoxically, natural resource wealth may



actually harm a country’s prospects for development – especially where it accounts for the bulk of government revenues, as in the case of rentier states ranging from Kuwait to Brunei.

The damage done by the resource curse, which was originally linked to the tendency for an abundance of resource exports to increase the exchange value of the currency and thereby make non-resource exports uncompetitive in world markets, now seems broader and more difficult to correct. Large windfall gains associated with a rapid increase in oil revenues have been a particular problem because they create severe distortions in the political system as well as in the economy. In countries as diverse as Iran, Nigeria, Venezuela and Indonesia, the “free lunch” aspect of

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oil revenues leads to government inefficiency and widespread corruption, undermining efforts to build the legal and social infrastructure that is needed for a market economy.

In Iran's case, no mark of economic failure stands out as much as the country's chronic unemployment. Between 1996 and 2000, 693,000 workers entered the labor market, while only 296,000 jobs were being created. Unemployment is somewhere between 15 and 25 percent, with a disproportionate share among urban youth. According to the World

may well be strongest when entrenched elites have access to oil revenues to muffle the discontent of the disenfranchised. It should not be surprising, then, that Iran's productivity actually fell in the first decade after the revolution and has stagnated since.

The proximate cause of the stagnant productivity in Iran is price distortion linked to regulation and subsidies. Subsidies on fuel, electricity, business loans and basic foods – intended to keep both the poor and their employers happy – run to tens of billions of dollars annually. Total consumer subsidies were

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Bank, the creation of jobs to stabilize unemployment at an acceptable level would require a growth rate of roughly 6 percent. And this rate has only been achieved in oil boom years.

Another broad measure of the health of a developing country is the rate of productivity change. In rich countries, productivity improvements are driven largely by new technology. In poor ones, it is more a matter of institutional flexibility – the capacity to move labor and capital from low-productivity activities (like subsistence farming and small-scale craft manufacturing) to high-productivity activities (like commercial agriculture and efficient-scale industry).

Almost inevitably, productivity growth makes some people worse off – for example, the local moneylender may find clients taking advantage of better terms at a new bank. Hence, change is resisted by many incumbent interests. And the success of the resistance

equivalent to 14 percent of GDP in 2001 and 2002. And energy subsidies alone amounted to \$16 billion.

The system encourages the waste of fuel that could easily be sold for foreign exchange. Fuel prices are about one-tenth of world prices; accordingly, Iran uses a staggering 16 times as much energy per person as India. Moreover, cheap fuel creates incentives to substitute machinery for labor – just what the doctor didn't order in a country crawling with unskilled, unemployed youth.

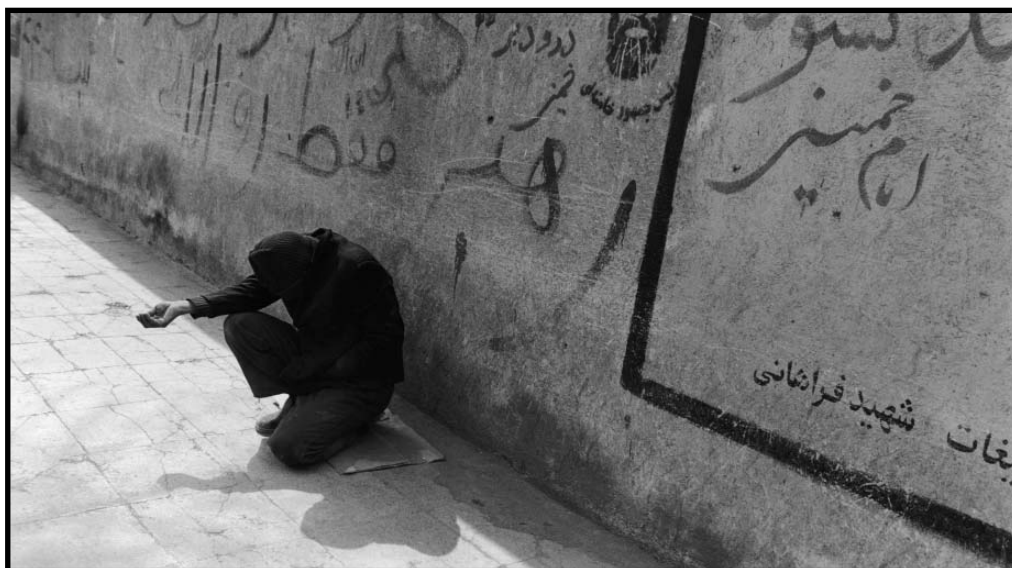
Equally important, oil revenues have, in effect, enabled the government to maintain money-losing state-owned enterprises. As might be expected, those enterprises have not been able to generate jobs. During the 1990s, about 70 percent of employment creation in Iran was in the private sector, in spite of the fact that state-owned enterprises dominate much of production. Note, too, that Iran's

state-owned enterprises are not held to international standards of accounting – and are thus an irresistible vehicle for corruption.

A striking peculiarity of the Iranian economy is the pervasive influence of non-profit foundations, known as bonyads, that function as huge conglomerate enterprises. They enjoy a long history of social and communal service in the Muslim world. In some countries, bonyads are under direct control of a

support for the regime, along with an enduring patron-client relationship. The regime draws support from this large clientele group in times of social unrest. But the lack of accountability virtually guarantees that much of the foundations' assets are diverted from their nominal goals.

State-owned enterprises and bonyads have been allowed to monopolize wide swaths of trade and business. The bonyads alone con-



government ministry. In others, they function semi-autonomously, but with some degree of government supervision. In Iran, such checks are largely absent.

The foundations' heads are appointed by the supreme religious leader and report to him rather than to the president or to Parliament. So there is no clear system of accountability. Periodic attempts by Parliament to assert control over them have been met by a stone wall.

The mullahs have used these foundations to help the poor and victims of the Iran-Iraq war – as well as to line their own pockets. This policy has created an important social base of

control 25 percent of GDP and enjoy preferential access to bank credit, hard currency, government licenses and lucrative contracts, thus crowding out more productive private sector activities.

For their part, the state-owned enterprises require massive subsidies from the government to stay afloat. Indeed, the political imperative to finance them largely explains why Iran has been plagued by chronic budget deficits. The country's post-1980 monetary expansion (and subsequent inflation) can be traced directly back to the government's unwillingness to oppose the credit demands of such politically powerful groups.



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The net effect of the government's massive subsidies, as well as its support of highly inefficient state enterprises and bonyads, has been to keep the country dependent on oil and to attenuate the rise of a more productive private sector needed to break out of economic stagnation. Oil revenues still represent 80 per-

cent of Iran's total exports and half of government revenues. The IMF estimates that the country's fiscal balances deteriorate by about 7 percent for every 10 percent decline in oil prices – a scenario that makes for a precarious economic future.

### **THE FUTURE – POSSIBLE ALTERNATIVES**

Has Iran's Islamic revolution failed? Others will have to judge the religious dimensions of the question. What is clear, though, is that the regime has failed to deliver on its self-proclaimed goals of social justice and prosperity.

Is there a way out of the economic morass? The orthodox prescription has been best laid out by the IMF, which has argued that the

country has reached a point at which business-as-usual is untenable. The balanced growth needed to tackle unemployment and poverty is simply not possible without a shift to free markets.

While few economists in the West would quibble with this assessment, Iran does not have the political will or institutions to carry out broad-based reforms. In fact, reforms carry major transition costs: increased unemployment in the short run as the state-owned enterprises shed weight or close their doors, as well as long-term pain for elites whose economic privileges would be challenged.

Other countries that have undertaken similar reform programs have usually done so only because they had little left to lose – and much to gain by qualifying for loans from the International

Monetary Fund and World Bank. However, high oil prices make it likely that Iran will be able to muddle along for the foreseeable future. Equally important, the coalition of interests with a stake in the status quo remains potent. The higher taxes needed to curb inflation and generate resources for infrastructure development would be costly to both incumbent businesses and to the bonyads. The same can be said for deregulation and efforts to curb restraints on commerce.

Privatization of state banks and insurance companies is bitterly opposed by the mullahs, both because it would undermine the ban on charging interest and because it would close off a cheap source of capital to the bonyads



and their business allies. Likewise, the replacement of ruinously expensive subsidies on consumer staples with a means-tested social safety net would undermine the Tammany Hall-style patronage machine that keeps millions of Iranians in political debt to the regime. And, of course, attempts to curb corruption would meet resistance from an army of petty officials who depend on it for much of their income.

The only recommendation by the IMF that might be acted upon – especially if oil revenue declines – is the privatization of the most capital-intensive state enterprises that

With U.S. sanctions firmly in place, an untested regulatory environment for foreign direct investment, and an as-yet-unchallenged tradition of cronyism and corruption in business, Iran has a long way to go before it is as attractive to foreign investors as, say, India, Poland or Mexico.

Also overlooked by the pragmatic conservatives is the fact that China bought its political quiescence with cultural and social liberalization, as well as with economic growth. The Islamic Republic, by contrast, shows no signs of being willing to bribe its aspiring middle class with similar concessions.

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are not major employers. By contrast, privatization of the bonyads' massive holdings would most likely be blocked by the religious elite, which effectively has veto power over virtually all legislation.

Led by Rafsanjani, the more pragmatic conservatives in Iran have their own plan: duplicate the Chinese model in an Iranian context. The idea is to offer economic growth, jobs and limited social freedom in exchange for support of the political status quo. As in China, direct and indirect taxes on productive new enterprises would keep the old guard well fed. These conservatives figure that Iranians would be content with rising incomes, and thus willing to give up their demands for political pluralism.

Is this a realistic alternative? The Chinese model relies on a massive inflow of foreign direct investment, which brings with it both managerial skills and up-to-date technology.

In any event, we aren't likely to see a test of the Chinese model anytime soon. Rafsanjani's pragmatic conservatives were solidly trounced by fundamentalist hard-liners in elections last summer. And the fundamentalists apparently aspire only to doing a better job of using oil wealth to buttress their interest-group coalition. Opening the economy to potentially disruptive foreign investment (and certainly disruptive foreign competition) is not part of the plan.

The saddest part here is that the gap between what Iran is and what it could be is so wide. Along with oil, Iran is endowed with a well-educated middle class. And, as is the case with Cuba and Palestine, expatriates would undoubtedly be delighted start businesses back home if the political climate were right. But for the moment, at least, Iran remains hostage to religious reactionaries and their camp followers. **M**