Oil in the Islamic Republic of Iran Dependence, Distortions and Distribution

Adeel Malik
University of Oxford

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Dependence, distortions and distribution

Massoud Karshenas and Adeel Malik

4.1 Introduction

Since it was first discovered in Iran in the early twentieth century, oil has continued to shape Iran's development trajectory in a significant way. By virtue of being a leading oil exporter in the world, Iran accumulates significant resources from oil. An abiding feature of its economy, in periods both before and after the 1979 revolution, is the close link between the vagaries of global oil markets and domestic economic fortunes.[1] This link has strengthened over time as Iran has become more dependent on oil revenues as a major source of foreign exchange, government revenue and savings.

This chapter traces the impact of oil on Iran's economic development. The influence of oil is mediated, among other things, through government policy, political structures and institutions. However, public policies are also influenced by the nature of the interests they serve. We therefore study Iran's development experience through the political economy lens, focusing not just on outcomes but on deeper political structures that produce and sustain these outcomes. This chapter argues that the story of oil and development in Iran revolves around three inter-related spheres of influence: dependence, distortions and distribution.

Iran's exports are overwhelmingly concentrated in oil, with the result that its economy is driven primarily by developments in the oil sector. At the same time, Iran has an overextended state that frequently disrupts markets and distorts the policy environment. It is one of those rare examples where *dirigisme*, or state-directed development, has run a very long course, surviving well into the twenty-first century. This *license raj* of the Middle East – manifested through planning, protection and economic controls – has been sustained through the continued inflow of oil resources. Without oil, it would have been difficult to sustain these restrictive institutions. Finally, Iran provides a fascinating account of how oil rents are shared with a wide constituency of supporters through a political redistribution of sorts.

The adverse effects of oil specialization that are typically associated with resource-rich economies are very much at work in Iran as well. For instance, Iran is no stranger to such pathologies as growth collapses, a weak tax effort, pro-cyclical fiscal policy, large government, delayed economic reform and an underdeveloped private sector. But Iran does not offer a straightforward demonstration of the resource curse. It started off with relatively favourable initial conditions. The country has a sizeable middle class and has never been directly colonized. From an early stage, Iran had implemented land reforms and made impressive gains in literacy. As a result, Iran enjoyed levels of development that preceded the stellar economic performance of East Asia. During the period 1959–77, for example, real non-oil gross domestic product (GDP) per capita in Iran grew at the rate of about 7 per cent per annum. By early 1970s, Iran's per capita income was twice that of South Korea. Yet, its economic fortunes diverged significantly in later years, with the result that, in 2005, its per capita income in purchasing power parity (PPP) terms was one-third of that in South Korea.[2] Ironically, if there was one country in the Middle East that was better positioned to convert its oil wealth into a blessing, it was Iran. The study of oil and development in Iran is therefore a sobering narrative of lost opportunities.

Oil, however, is not the only factor that greases the wheels of Iran's political economy. In many ways, Iran's development experience is shaped by the confluence of three factors: oil, ideology and isolation. The policies and development outcomes that we analyse in this chapter are as much a product of Iran's distinct ideological heritage, principally the legacy of the 1979 Islamic revolution, and its international isolation. The US sanctions against Iran, the freezing of its assets, the protracted war with Iraq and its continuing economic and political isolation provide an important context that has forced Iran to look inwards and pursue more protectionist policies. Of course, this was reinforced by the political influence of interest groups within Iran who benefited from the country's protectionist policies. A proper analysis of these non-oil influences lies beyond the remit of this chapter, but it is worth recognizing them at the outset.

The discussion in this chapter is organized into six sections. Section 4.2 sets the context for our analysis by providing a brief description of natural resource endowments, institutions and major economic developments since 1960s. Section 4.3 describes arrangements in the oil sector. The macroeconomic consequences of oil are discussed in Section 4.4, whereas the associated political economy issues are developed in Section 4.5. Finally, Section 4.6 offers some concluding remarks.

4.2 The context: endowments, history and institutions

This section will set out the resource and institutional context of the Islamic Republic of Iran. It will define the nature of initial conditions that modulate the context in which oil shapes economic development in Iran.

4.2.1 Resource endowments

Iran is endowed with significant natural resources, which consist mainly of hydrocarbon reserves. The World Bank's wealth estimates indicate that natural capital constitutes about 59 per cent of total wealth in Iran.[3] Oil and natural gas constitute 73 per cent of total natural wealth. It is the fourth largest oil producer in the world, and its proven oil reserves are second only to Saudi Arabia. Current International Energy Agency (IEA) estimates of oil reserves suggest 93 years of production at current extraction rates. Iran also has significant gas reserves, amounting to 15 per cent of proven global reserves – second highest after Russia. The South Pars field, which is one of Iran's largest offshore gas fields in the Gulf and contains 8–10 per cent of world gas reserves, has recently attracted considerable foreign investment. However, Iran's gas sector is less developed compared with its regional competitors, Oman and Qatar.

Although hydrocarbons are the dominant natural resource in Iran, the country is also endowed with mineral deposits, including copper, iron ore, bauxite, coal and gold, among others. 'Around 80m tonnes of minerals are quarried every year from some 1,500 non-metallic and 50 metallic mines' (EIU, 2008). Within the mineral category, the copper industry has assumed growing significance. Iran holds 4 per cent of the world's copper deposits. The reserve at Sar Chesmeh near Kerman is the second largest deposit in the world, containing an estimated one billion tonnes of ore.[4]

4.2.2 The structure of the Iranian state

The political economy of post-revolutionary Iran stems from the unique structure of the Iranian state. Iran has a dual structure of power, whereby the official state, namely the elected parliament and the executive, coexists with the unelected core state controlled by the clergy and headed by the supreme leader. The core clerical state, apart from having control over important state apparatuses such as the judiciary and the armed forces, also screens candidates who can take part in parliamentary and presidential elections, has veto power over the legislation passed by the parliament and exerts considerable influence over the day-to-day affairs of the official government through a variety of informal channels.

Within this institutional architecture, several organizations are assigned the task of supervising, overseeing and coordinating national decision making. For example, a conservative vetting body known as the *Guardian Council* ensures the consistency of parliamentary laws with the Islamic injunctions. Any possible conflicts that might arise between the *Guardian Council* and *Majlis* (the elected parliament) are mediated by another institution of the core state, the *Expediency Council*.

This duality of the state structure complicates our analysis of how core decisions regarding the extraction and use of natural resources are actually made in Iran. It would be oversimplistic to treat the Iranian state as an autonomous and unitary state and analyse the five decision points around: negotiations, contract design, transparency in revenues, and savings and expenditure policies. The dual state structure in Iran translates into a multiplicity of power centres, representing different coalitions of social, economic and religious interests. Various factions attached to these power centres are sustained through elaborate informal networks.

This duality of power structure provides an important context for analysing Iran's political economy. The dual structure sows the seeds of 'embedded factionalism', which generates destructive competition over power and resources (Bjorvatn and Selvik, 2008). The distinct structure of the post-revolutionary state – and its supporting constituencies – has in turn a determining influence on how hydrocarbon revenues are channelled to the society. The different economic and political interests that these factions have come to represent are therefore key drivers of macroeconomic policies. It serves as the essential backdrop against which much of Iran's political economy can be explained – be it redistributive fiscal policies, the nature of economic distortions or rents from natural resources.

To see why this state structure is central to explaining Iran's political economy, consider the economic clout of charitable organizations (*Bonyads*) and the Revolutionary Guards (*Sepāh e Pāsdārān e Enqelāb e*

Eslāmi), both of which operate in semi-autonomous public domains and are indirectly controlled by the core state. They receive significant public funding and are broadly exempt from public accountability. Although the core unelected state has no direct budgetary influence, it has significant indirect stakes in these semi-public organizations. For example, these semi-public organizations are crucial vehicles for dispensing patronage to various political constituencies. In short, the core state is believed to control vast economic assets through these 'shadow' economic forces. Its economic interests are reflected in a variety of public policies from the terms at which bank credit is allocated to the pace of economic reform and the nature of 'privatization' of public assets. Many of these stories will form an essential part of ensuing discussions in this chapter.

4.2.3 Growth cycles and institutional changes since the 1960s

This section will provide a brief overview of the key political economy developments of Iran since the 1960s. For this purpose, we will define the economic history of Iran in three distinct periods, namely the pre-revolution period (1960–78), the decade of revolution and the Iraq war (from late 1979 to the late 1980s), and the period since the end of the Iran–Iraq war. Each period can in turn be divided into various subperiods according to different criteria. Figure 4.1 shows one such categorization based on cycles in GDP growth.

A description of the salient features of economic development in each phase will form a useful backdrop for analysing the management of oil revenues and its consequent impact on economic growth.

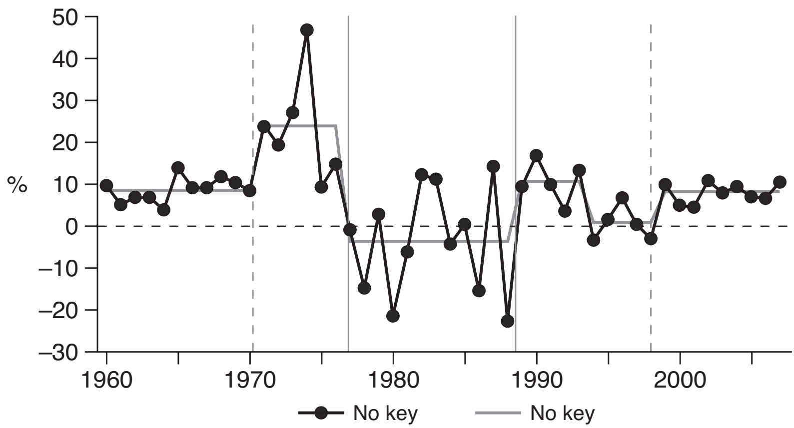

Figure 4.1 GDP growth cycles, 1960–2007.

4.2.3.1 The pre-revolution era

The period prior to the 1979 revolution can be viewed as consisting of two subperiods (see Figure 4.1). One is the long period of sustained economic growth during the 1960s up to the oil price boom of 1972–74. During this period, GDP growth in Iran was among the highest achieved by any country at that time on a sustained basis. It is also remarkable that such high growth performance in Iran was achieved with relative price stability and low inflation (consumer prices index (CPI) inflation was 1.7 per cent a year during the 1960s). This was made possible by a steady growth in oil export volumes, of over 12 per cent a year, giving rise to a stable flow of foreign exchange proceeds. This helped to sustain the rapid pace of import-substituting industrialization (ISI). Growth in the pre-revolution era was also driven by: (1) generous investments in infrastructure and heavy industry; (2) land reforms; and (3) higher educational investments. These became the enabling conditions for sustained growth.

The second subperiod in this phase coincides with the oil price hike of 1972–74 and the mismanagement of oil revenues by the government, which led to an overheated economy and a subsequent recession that began as early as 1976. This also ushered in the end of the long secular trend of growing oil export volumes which began in the mid-1950s. Iranian oil production reached its peak in 1976. The economic system in this phase can be characterized as a mixed market economy, akin to the systems commonly prevalent in other developing countries at the time. Public investment was conducted within the framework of 5-year development plans, and was mainly concentrated in infrastructure and heavy industry.

Government planning in this period was complementary to private sector activities, and public incentives became instrumental to private sector growth. A strong ISI strategy was pursued behind high tariff walls and concessionary development finance. Development banks provided targeted credit subsidies and relevant technical assistance. A new class of industrialists emerged who energetically introduced many new industries and technologies in close association with foreign capital. The land reform programme during the 1960s also undermined the established absentee landlordism, opened the agricultural sector to commercial farming and increased the mobility of labour.

After having grown on a sustained basis for nearly two decades since the mid-1950s, oil exports slumped in the second half of the 1970s. The end of the oil era had tested the industrialization strategy of the 1960s. The absence of significant productivity improvements and the lack of solid institutional foundations made growth unsustainable. A complicating factor was the macroeconomic mismanagement that followed after the oil boom of the early 1970s. Oil windfalls led to a major spending drive that proved inflationary, but also facilitated rent-seeking activities with associated inefficiencies. The time had come for economic reform and the adoption of a new development strategy, which should have implied a change from a top-down development strategy to one in which the new industrial class was assigned a greater strategic role, in both economic and political terms. Whether the Shah's regime was capable of such a move is a question of historical interest only as, with the onset of the 1979 revolution, events took a dramatically different turn.

4.2.3.2 The phase of revolution and war

The second period begins after the revolution in 1979 and the subsequent war with Iraq which continued during much of the 1980s. The external context was adverse during this period, in terms of both falling oil prices and the changing geostrategic context. The drastic fall in oil exports precipitated an economic decline. By 1988, real per capita national income had declined by 50 per cent from its peak in 1976. Iran's status in the western community switched from being a friend to being a foe, inviting sanctions and international isolation. This brought profound changes in Iran's political economy and shaped the contemporary economic and political structures in important ways. The foundations of the dual state structure, where the elected parliament coexists with the unelected core state, were laid in this period (see Section 4.2.2 for background).

At least three developments are noticeable during this post-revolution period. First, there was a large-scale nationalization of the banking, industrial and services sector. Second, the Iranian state assumed an overextended role in the economy by imposing direct controls over the market. Third, as a necessary consequence of international isolation and domestic economic intervention, the post-revolution years saw an emergence of entrenched interest groups.

At the time of the revolution, almost all of the modern large-scale enterprises in industry and services, including the banks, were taken over by the state. A large part of these assets was transferred to semi-private charitable institutions (*Bonyads*), which have come to dominate the economy by accumulating vast assets in recent years. They operate under the auspices of the office of the supreme leader and, apart from their dominant control of the large-scale non-government enterprise sector, they also wield considerable political power. They obey neither the laws of public enterprises nor those of the independent private sector. These charities are exempt from taxation, and their accounts are not publicly disclosed. By the end of this period, the large-scale enterprises were predominantly controlled either by the government or by the semi-official *Bonyads*.

This appears to be in line with the economic system envisaged in the constitution of the Islamic Republic, where the private sector was assigned a relatively minor role. The expanded role of the state in the economy was not solely confined to a shift in the balance from private to public ownership. It was also manifested in an intricate system of direct controls over the operation of markets, from foreign exchange controls and the maintenance of a system of multiple exchange rates to the control of interest rates and allocation of bank credits, as well as rationing and direct price controls in a large number of product markets.

By the mid-1980s, the black market exchange rate had a 2,000 per cent premium over the increasingly overvalued official exchange rate. The twenty-fold premium in the parallel exchange market was indicative of the enormous subsidies that the oil sector provided to those who benefited from the government's foreign exchange rationing system. Similar subsidies were granted through the subsidization of consumer products and key producer inputs, such as energy. By the end of the decade, the prices of some key products such as energy and bread had fallen to well below 10 per cent of international prices (see, for example, Karshenas and Pesaran, 1995). Some of this came about as a result of the exigencies of running a war economy, but over time, the resulting price distortions gave rise to entrenched interest groups, which made the task of reform difficult in later years.

4.2.3.3 The post-war period

The third phase began with the ending of the Iran–Iraq war. In many ways, this constitutes the pragmatic phase of the Islamic Republic. It began with a partial liberalization and economic reform programme, combined with a large reconstruction and investment effort undertaken by the government. Economic planning, which had been abandoned during the war years, was reinstated with the first 5-year plan of the Islamic Republic under President Rafsanjani. Privatization of state enterprises appeared on the policy agenda. A significant reform was the unification of the exchange rate in March 1993.

Even partial reform effort proved short-lived, however. Unbridled expansion of bank credit and unsustainable foreign borrowing led to the abandonment of the reform programme. The bulk of foreign debt in 1993 was in short-term commercial credit. In the presence of US sanctions, the government faced difficulties in rescheduling these debts, forcing it to reintroduce trade and foreign exchange restrictions. By December 1993, the foreign exchange unification policy was effectively given up. The rest of the 1990s was a period characterized by economic retrenchment and repayment of the public debt accumulated during the boom in the early 1990s.

At a deeper level, however, there has been limited reform in the basic economic structure of the Iranian state that emerged during the first decade of the revolution. If anything, there has been a considerable shift of economic power from the official elected government – the 'legal rational' arm of the state – towards the less transparent and more murky and informal core state, with the independent private sector being increasingly marginalized. Since the early 1990s, the process of privatization has continued with ups and downs. This process received a major push under President Khatami's third 5-year plan, which ratified an ambitious privatization programme despite opposition from sections of the core state. By and large, the privatized government enterprises have, however, either been taken over by the semi-public *Bonyads* or sold via public offering in the Tehran stock exchange with majority shares being controlled by government-owned banks and other public or semi-public institutions. Privatization has, however, posed a limited challenge to the government's dominant role in the economy. In many cases, privatized assets have simply been transferred from the state to semi-public organizations.

Privatization continues to remain on the policy agenda, with greater constitutional and political support being accorded to the process.[5] A new executive order by the supreme leader in 2006 has directed the government to privatize government enterprises by the end of the fifth development plan (2014). Government ownership will be limited to a few strategic activities such as upstream oil and gas, selected banks and a few companies in the utilities and transport sectors. The majority of shares will be sold to non-government foundations at 50 per cent discount and will be managed on behalf of the poor (IMF, 2007).

Despite the variable economic record, there are two favourable trends that have gained strength since the 1960s, and therefore deserve a proper mention. These relate to the important demographic and social changes in Iran. Besides the introduction of land reforms, the 1960s saw the introduction of family law and a vigorous campaign for family planning. In the pre-revolution period, the population grew at an annual average rate of 2.8 per cent, but it slowed down during the 1970s. Although the rate of population growth initially increased after the revolution because of war and the pro-natal policies of the government, it has subsequently fallen as a result of the resumption of an effective family planning programme. The population growth rate, which had risen to 3.9 per cent in the 1980s, has fallen to 1.5 per cent since the early 1990s. This has had important implications for the country's demographic profile and labour force dynamics. Another underlying factor has been a steady improvement in education and health indicators. Mean years of schooling increased from about 1 in the early 1960s to 3.4 in the early 1980s, 5.1 in 2000, and close to 6 in 2008.[6] In the early 1970s, mean years of schooling were well below international norms; by the year 2000, however, Iran had achieved levels of education that were more commensurate with its per capita income.

4.3 Oil sector arrangements

Iran was the first country in the Middle East where oil was discovered and exported in the early twentieth century. Iran was also the first country where oil was nationalized in the early 1950s. The National Iranian Oil Company (NIOC) was the first national oil company in the Middle East set up at that time to manage the oil industry on behalf of the government. With the defeat of the oil nationalization movement in effect up to the early 1970s, the major part of the oil reserves was under the control of foreign oil companies under the commonly prevailing 50:50 profit-sharing agreement. From the early 1970s, along with other oil-exporting countries in the Middle East, effective control of all oil reserves was taken over by the NIOC, which operated under production-sharing agreements with foreign oil companies up to the 1979 revolution.

Since the 1979 revolution, production-sharing agreements have been replaced by the so-called *buy-back agreements*, a mixture of service contract and limited production-sharing agreement. These agreements grew out of Iranian sensitivity about retaining local control of the country's natural resources while at the same time attracting the skills and resources of foreign firms. As part of these contracts, a 'foreign investor develops the designated field according to a previously agreed budget, hands over the facility once production starts and is reimbursed, with an agreed profit margin, from the proceeds of the field's output over a fixed period'.

The design of these buy-back agreements is believed to have led to underinvestment in the oil sector. The relatively inflexible terms of the buy-back agreements together with strict constitutional limits on local control of the oil fields has caused delays in the completion of projects. Negotiations with foreign firms have been further prolonged by a dearth of suitably qualified professionals in the oil ministry and NIOC. Buy-back contracts can also lead to considerable inefficiency and limit technology transfer by forcing the foreign oil companies to take only a short-term interest in the oil projects at the expense of long-term efficiencies.

Overall, Iran has not fully exploited its potential for attracting foreign resources for oil sector development. Officially recorded foreign investment in the oil sector constitutes no more than 0.01 per cent of GDP. The inflexibility of Iran's distinct contracting arrangements, together with a hostile international environment, has impeded efforts to expand oil production. Three constraints are particularly note worthy: (1) the war with Iraq; (2) US sanctions since 1997; and (3) growing domestic demand for fuel.

Oil production peaked in 1976 and has subsequently declined after the 1979 revolution and the war with Iraq in the 1980s. Soon after the revolution, oil production dropped from 5 million to 1.5 million barrels/day (bbl/d). Production has picked up since the end of the Iraq war, but remains well below the pre-revolution levels (see Figure 4.2). In recent years, the country has been struggling to raise oil production, bringing it up to 3.8 million bbl/d. But even to maintain these production levels, Iran needs to add approximately 300,000 bbl/d of output every year, which requires substantial new investments to upgrade Iran's ageing fields.

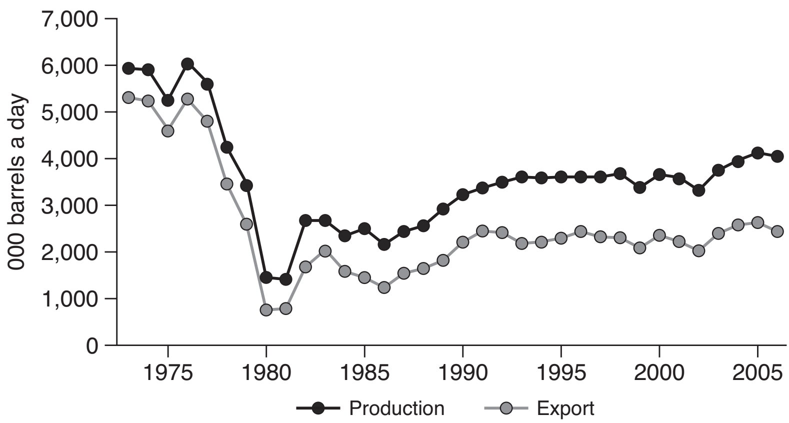

Figure 4.2 Crude oil production and exports.

Direct US sanctions against foreign investment in Iran's energy sector have been another key inhibiting factor.[7] US sanctions have slowed down the development of oil fields, even though Iran has been successful in attracting resources from non-US sources (mainly Europe and China). The impact of US sanctions has been estimated to cost the Iranian economy to the tune of 1.1 per cent of GDP annually (Torbat, 2005). Iran has neither the skills nor the requisite financial resources to fully compensate for this underinvestment in the oil sector.

Iran's capacity to invest in the energy sector is strained by growing domestic demand for subsidized fuel and limited local refining capacity. This has drained both government revenues and the exportable surplus of oil. Crude oil exports have stagnated since the early 1990s. A growing population at home and subsidized provision of fuel have raised domestic demand for oil. On average, domestic oil consumption has grown annually at the rate of 4.3 per cent during the period 1999–2006. Owing to a lack of domestic refining capacity, Iran needs to import more than 50 per cent of its petrol. Imports of refined oil have therefore increased from 60,000 bbl/d in 1990 to well over 260,000 bbl/d. Recently, Iran has encouraged the substitution of gas for oil in domestic consumption in order to release a greater exportable surplus of oil.

Regardless of these external and domestic constraints to the extraction of oil, revenues accrued from the sale of natural resources are recorded and disclosed with relative transparency. Oil, gas and other mineral resources are treated as national wealth, and revenue from these are consistently recorded in budget documents and balance of payment accounts. There is also no direct evidence of any large-scale misappropriation or illegal diversion of oil revenues. In this respect, Iran fares markedly better than many of its peers in the resource-rich Middle East, where the distinction between public and private wealth is more often blurred. There is no evidence of crude misappropriation of oil revenues. Issues of transparency arise indirectly through channelling of rents to favoured interest groups. Macroeconomic policies often serve as convenient tools for such political redistribution. We will spell this out more clearly in subsequent sections.

4.4 Oil and the macro-economy

Oil is a central driver of macroeconomic developments in Iran. There are three key aspects of the role of oil in Iran's economy: a provider of government revenue, a source of foreign exchange and a supplement to domestic savings. These three aspects of the contribution of oil revenues – government finance, savings and foreign exchange contributions – and the problems they pose for the management of the economy are the subject of this section. Figure 4.3 traces the evolution of the share of oil in total exports, savings and government revenues since 1959.

Historically, the Iranian economy has shown a high degree of dependence on the proceeds from oil exports. As shown in Figure 4.3, crude oil exports have consistently constituted over 80 per cent of foreign exchange revenues over the past five decades. The contribution of oil revenues to the government budget has also been consistently high. In fact, as shown in Figure 4.3, during the more recent growth period of 1999–2007, the share of oil revenues in total government revenues has been well above the early growth phase of 1960–71. Oil revenues have also made a sizeable contribution to national savings. This is particularly evident during the two oil booms in the 1970s and 2000s. Oil's contribution to exports, government revenues and savings has also shown considerable volatility since 1959, closely tracking movements in oil prices. Cycles in the domestic economy are therefore directly linked to developments in the oil sector. The next section will separately examine the effect of oil on the national budget, savings and investment.

4.4.1 Oil and the budget

Oil's most direct channel of influence on the domestic economy is its effect on the government budget. Table 4.1 presents the evolution of different aspects of the central government budget since 1965. An

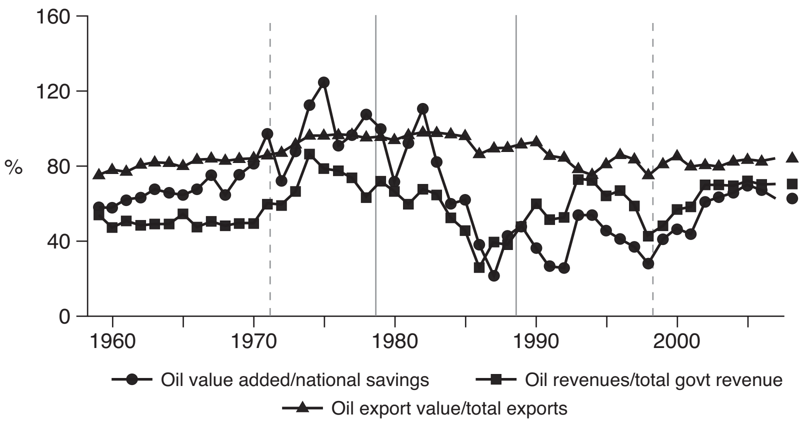

Figure 4.3 Share of oil in exports, government revenue and national savings.

important clarification to note here is that data on oil revenues in the 1980s and 1990s are not strictly comparable with other decades. This is because oil revenues during these two decades were converted in highly overvalued official exchange rates. This generated hidden subsidies and transfers to those who had access to foreign exchange at official rates. With the unification of the exchange rate in 2002, however, these subsidies have been made explicit. Notwithstanding these caveats, the evidence provided in Table 4.1 confirms the observation we made earlier: oil revenues dominate the trends and cycles in government revenues. Furthermore, unexpected increases in oil revenues have often led to a spending bonanza.

What stands out from Table 4.1 is the extremely undeveloped fiscal machinery of the government, as indicated by the very low and declining share of taxes in GDP. This enhances the country's dependence on oil revenues. Few people pay direct income taxes; their share in GDP is a paltry 1 per cent. The main contribution to tax revenues comes from corporate and import taxes. Even corporate taxes remain low, and have

Table 4.1 Central Government Budget, 1965–2007 (% of GDP)

	1965–67	**1975–77**	**1985–87**	**1995–97**	**2005–07**
Total revenues	20.6	43.3	14.1	22.1	30.2
Oil revenues	10.5	33.3	5.4	14.0	21.2
Tax revenues	8.4	8.3	6.6	5.0	6.1
Corporate tax	–	3.2	2.4	2.1	2.2
Income tax	–	1.0	1.0	1.1	0.9
Wealth tax	–	0.3	0.3	0.2	0.3
Import tax	–	3.0	1.5	1.1	2.0
Sales and consumption tax	–	0.8	1.4	0.4	0.7
Other revenues	1.7	1.8	2.1	3.2	2.6
Expenditure	23.6	49.6	21.6	22.4	28.3
Current	14.8	30.8	16.8	15.2	19.7
Development	8.9	18.8	4.8	7.2	6.6
Budget deficit/surplus	–3.0	–6.3	–7.5	–0.3	1.8
(% of non-oil GDP)	–3.7	–10.0	–8.0	–0.3	2.5
Non-oil balance	–13.5	–39.5	–12.9	–14.3	–19.4
(% of non-oil GDP)	–16.4	–63.8	–13.8	–16.9	–26.6

The consolidated budget of the central government includes the stabilization fund and net transfers to state-owned enterprises, but excludes the budget of municipalities and local governments financed by local taxes.

Source: Central Bank of Iran and IMF (2006).

actually declined as a share of GDP since 1977. This is surprising in the face of a growing corporate sector and a shrinking share for the agricultural sector. A partial explanation for this may have to do with the growing role of charitable foundations (*Bonyads*) that dominate Iran's corporate sector yet remain outside the tax net. In 2008, the government attempted to reform the tax system by introducing a 3 per cent value added tax, but this has been resisted by protest marches and the closure of the bazaars in some major cities.

Another notable aspect of the dependence of public spending on oil revenues relates to the speed with which unexpected increases in oil revenues are translated into government expenditures. Despite the existence of long-term expenditure plans, increases in government revenue, over and above those budgeted within the development planning framework, were immediately translated into increased public expenditures. This tendency of government expenditures to closely track movements in oil revenues is common across both the pre- and the post-revolution periods.

An important institutional development for Iran's fiscal regime was the establishment of the Oil Stabilization Fund (OSF) in 2000. The primary objective of the OSF was to collect surplus petroleum receipts for smoothing out the effect of unexpected oil price fluctuations. A secondary objective was to promote investment in priority sectors. At least 50 per cent of the fund's balances are set aside as foreign exchange loans to the private sector through commercial banks. In principle, government withdrawals from the OSF for budgetary purposes are discouraged, requiring ratification by the parliament. In practice, the OSF is frequently raided to meet budgetary needs. Table 4.2 presents OSF accounts

Table 4.2 Oil Stabilization Fund (OSF) operations, 2000–06 (in US$ billion)

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Total inflows	5.9	1.8	5.9	5.8	10.4	13.0	21.6
Total outflows	0.0	0.8	5.1	5.4	9.4	11.5	23.0
(Transfers to the central govt budget)	0.0	0.4	4.5	5.3	7.5	7.8	17.8
(Net domestic onlending)	0.0	0.1	0.6	0.1	1.8	2.1	5.3
Valuation adjustments							0.3
OSF balance	5.9	1.0	0.8	0.4	1.0	1.5	–1.1
Memorandum items:							
OSF stock of foreign exchange deposits at the Central Bank	5.9	7.0	7.8	8.1	9.1	10.7	9.5
OSF stocks of domestic loans	0.0	0.1	0.7	0.8	2.6	4.8	10.0

Source: IMF (2008).

for the period 2000–06. A striking finding from Table 4.2 is that over 80 per cent of the funds have been transferred to the central government budget since the creation of the OSF.

In 2006 alone, withdrawals by central government were equivalent to the entire assets of the OSF at the end of 2006. By the end of 2007, the OSF had foreign exchange deposits of about US$22 billion and a domestic loan portfolio of US$14.4 billion. With the recent rapid increase in oil prices, the transfer of funds from the OSF to the current budget has increased rapidly, standing at over US$20 billion in 2007. In fact, 90 per cent of the actual budget deficit in 2007 was financed through OSF withdrawals (Farzanegan and Markwardt, 2009). Considering that the rise in oil revenues over this period is mainly attributable to higher oil prices rather than an expansion in output or exportable surplus, this high degree of reliance on OSF funds, apart from leading to short-term inflationary pressures, is a recipe for fiscal crises and more serious instability in the medium and long run.

The apparently similar spending responses of the pre- and post-revolution governments to oil price booms can convey the misleading impression that the underlying political economy has remained unchanged. Quite the opposite; prior to the 1979 revolution, the government was a highly centralized and unified technocratic entity, which had a relatively high degree of autonomy from underlying societal forces. Many of the economic problems during that era were associated with top-down planning that is characteristic of a centralized state. It was also responsible for the overheating of the economy during the 1973–74 oil boom, as the technocrats did not have the power to stand up to the grandiose dreams of the Shah when he ordered a quadrupling of the size of the fifth development plan.

The political economy of the Islamic Republic is markedly different, however. The dual power structure of post-revolutionary Iran introduces critical differences in the resource allocation mechanisms between the two regimes. A different set of fiscal priorities is now shaping patterns of public spending. For example, the core clerical state now controls vast economic assets and often uses them as a means for rewarding its supporters through employment generation and charitable transfers.

An important change in the structure of the budget during the post-revolution period is the decline in the share of government development expenditure and the relatively large increase in the share of current expenditures (Figure 4.4). This is not an unexpected result for the war years of the 1980s, when both the drastic cut in oil revenues and the war

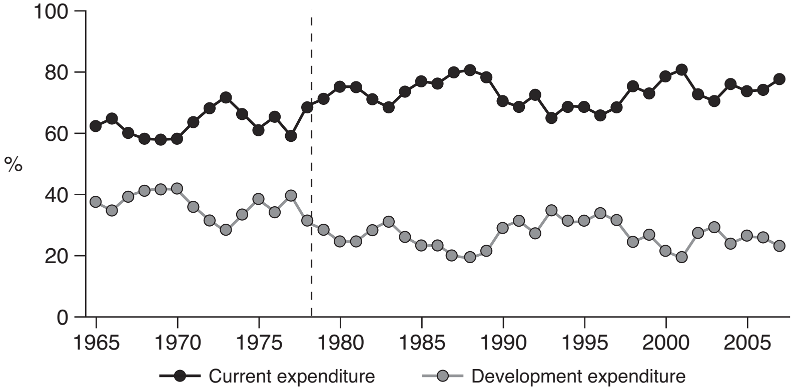

Figure 4.4 Share of current and development expenditure in the government budget.

effort had strained public finances. Development expenditures did pick up after the war, returning roughly to pre-revolution levels.

But this surge proved short-lived. The share of current expenditures in government spending has grown since the mid-1990s. Perhaps more surprisingly, the share of development expenditures has remained low despite growing oil revenues since 1999. This may partly be a result of the new interpretation of Article 44 of the constitution, which prevents the official government from engaging in industrial and commercial investments. However, this still does not explain the underinvestment in infrastructure, especially electricity generation activities.

What explains this rising share of current expenditures? These growing expenditure commitments reflect in part the political compulsion to create public employment and to maintain generous public subsidies. For example, food subsidies have more than doubled, increasing from about 1.4 per cent of GDP in 2000 to about 3 per cent in 2007.[8] This was a period when public development spending did not exceed 5 per cent of GDP, on average. Implicit subsidies arising from the underpricing of energy and other public utility services have been an even more important drain on government revenues. Recent International Monetary Fund (IMF) estimates indicate that implicit subsidies in the oil and gas sector amounted to roughly 20 per cent of GDP in 2007 (IMF, 2008).[9] Even though most oil-rich states tend to subsidize the domestic price of oil, Iran has one of the lowest oil prices in the region.

Under these conditions, the growing share of current expenditures has not necessarily meant an improvement in the quality of public service provision. On the contrary, the quality of public sector health and educational services appears to have been deteriorating, as those who can afford it appear to be making increasing resort to private health and educational services. Figure 4.5 shows how public spending per student has been declining as a share of per capita GDP during the post-revolution period.

4.4.2 Oil, savings and investment

Like other macroeconomic outcomes, savings and investment behaviour in Iran is mainly driven by developments in the oil sector. This is vividly demonstrated in Figure 4.6, which shows how aggregate savings

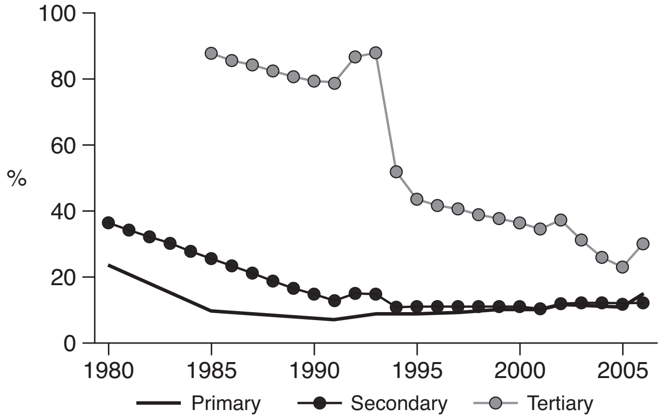

Figure 4.5 Public expenditure per student (percentage of per capita GDP).

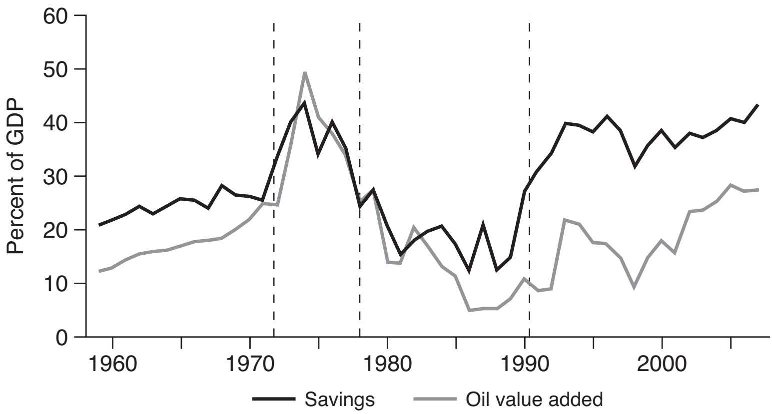

Figure 4.6 Savings rates and share of oil in GDP, 1959–2007.

(as a share of GDP) have closely tracked the share of oil value added in GDP.[10] Excluding the exceptional years, principally the first oil boom in the early 1970s and the Iran–Iraq war, the considerably high savings rate during the period 1991–2007 stands out in Figure 4.6. How can these high and rising savings rate since the 1990s be explained relative to the historical norm? Preliminary estimates indicate that a major part of savings is generated by the private sector, aided by the rapid population transition that Iran has witnessed since the 1990s. Household savings have risen in response to a young and rapidly growing labour force combined with rapidly declining birth and dependency rates.

The dependence of savings on oil revenues tends to alleviate the need to mobilize domestic savings. This, in turn, weakens the prospects for financial sector development. Saving behaviour in Iran is closely tied to two broader issues: the mechanisms for mobilizing savings and their allocation to investment opportunities. Iran's distinct institutional set-up, especially the nature of its financial system, holds the key to explaining these saving patterns. By and large, banks are government owned, and their lending and credit allocation policies are broadly reflective of government priorities. The state has often used these banks as vehicles for selectively allocating credit to preferred production sectors, regions and activities. With such profound state intervention, Iran is one of the few countries where aspects of financial repression continue to shape financial development. We will take up the issue of financial sector development in greater detail while analysing the investment process in Iran.

4.4.2.1 Investment

Figure 4.7 traces the evolution of aggregate savings, investment and fixed investment, all expressed as a share of GDP.[11] As expected, investment rates have been very erratic. Some peculiar features of the investment patterns can be quickly noted:

- Investment rates have been generally higher during the 1990s relative to the 1960s.
- Despite higher investment rates in the 1990s, GDP growth has been well below that achieved during the 1959–73 period. This raises important questions about the efficiency of investments in the 1990s, which is surprising given the availability of a more educated labour force relative to the 1960s.
- While investment has been high during the 1990s, it has remained significantly below its potential, especially bearing in mind the high saving and growth rates during this period.

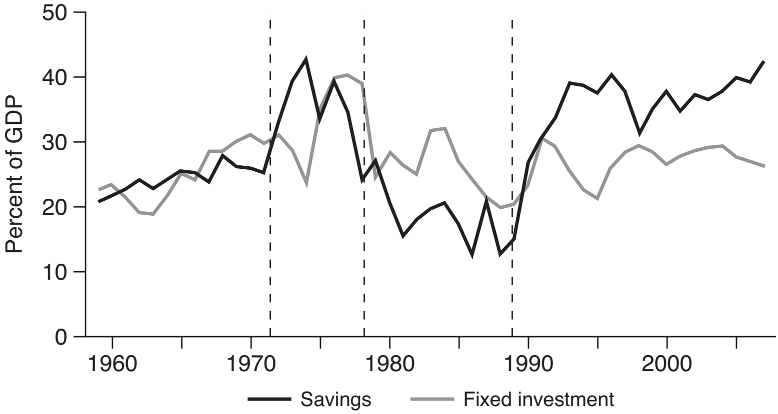

Figure 4.7 Savings and investment rates, 1959–2007.

Overall, Iran has enjoyed respectable levels of investment. For instance, the share of gross fixed capital formation in GDP was 36.9 per cent in 2007. But the story on investment is more complicated than the aggregate statistics tend to reveal. If the Central Bank statistics are to be believed, the higher share of aggregate investment during the past two decades has mainly been driven by private investment. This is not always borne out by data from the Central Statistical Office (CSO): the ratio of private to public investment has generally been lower according to the CSO data.

Lurking behind this apparent discrepancy between official statistics is the role of parastatals in the Iranian economy. Investment expenditures by the quasi-state institutions (e.g. *Bonyads*) are often treated as private investment even though, for all practical purposes, these investments are directly or indirectly controlled by the 'core' state, albeit in a haphazard and uncoordinated manner. A significant part of what is considered to be private investment is thus effectively public investment. Overall, public expenditures remain a key driving force for private economic activity. Even when undertaken by purely 'private' agents, investment is shaped mainly by government expenditures and policies. The Iranian government has shaped private investment through the allocation of cheap credit by the banking system, the provision of subsidies, exchange rate policies and various protective measures in the product markets.

The investment process cannot therefore be properly analysed without due mention of the overextended role of the Iranian state, afforded in large part by oil revenues. Oil has sustained a large government and its interventionist policies. The state has played an overarching role in shaping the non-oil economy through its policies and institutions. It would be fair to say that public policies have more often been a cause for distortions rather than development. They have hindered the growth of a vibrant private sector. Despite the growing industrial share in GDP, the manufacturing sector accounts for a small proportion of GDP (less than 11 per cent).

Iran has failed to exploit its full potential for private industrial development. Although the manufacturing sector is weak, it has a non-negligible presence, especially when compared with Iran's other oil-rich neighbouring states in the Middle East. Iran has significant stakes in the steel and petrochemicals industries; in fact, it has the largest steel industry in the entire Middle East. It also has a heavily protected car industry that has recently formed joint manufacturing ventures with foreign motor manufacturers.

Despite this industrial presence, Iran's non-oil economy rarely provides the sort of cushion that is required to deal with the vagaries of the oil markets. Oil continues to play a decisive role in shaping the non-oil sector. A cursory look at the macro data confirms this. Trends in aggregate investment, for example, have mirrored movements in oil prices. High and rising oil prices have tended to drive market sentiment and raise investment levels. All oil booms, including the most recent one, confirm this pattern. Even though Iran's investment levels are not very low by regional comparison, the private sector is unlikely to be the main driver of these investments. Iran's private sector is weak, uncompetitive and lives under the shadow of a dominant state sector. This explains why relatively high saving and investment levels have not translated into commensurate growth rates. The principal explanation for this has to do with the low efficiency of investments.

Industrial inefficiencies have increased dramatically under the Islamic Republic. The efficiency of capital has fallen drastically over the last four decades: from an annual growth of 4.7 per cent during 1960–76, growth in total factor productivity was reduced to 1 per cent annually during 1989–2002 (IMF, 2004: 12).[12] Old industries in the public sector and the semi-public institutions are badly in need of restructuring. The continued existence of these inefficient industries is incompatible with the objectives of export diversification and growth in the non-oil economy. The World Bank estimates on the wealth of nations tend to confirm this low productivity of capital. Intangible capital, which is the main source of wealth generation in developing societies, plays little part in the growth of the economy (World Bank, 2006: 29).

This is archetypical of resource-rich societies, which produce too little given their potential, and have lousy investment that reinforces the resource curse (van der Ploeg, 2008).

These industrial inefficiencies have tended to persist, thanks to the easy availability of oil resources. Oil revenues have allowed the Iranian state to compensate for organizational and production inefficiencies, mainly by injecting public resources in the guise of subsidies or direct investment. Although the effect of such inefficiencies may be cushioned in the short run through the availability of oil revenues, they can make development unsustainable in the long run. The nature of structural change in an oil economy such as Iran is crucial for sustainable development. A crucial aspect of structural change is the extent to which industry, agriculture and other sectors can replace the role of oil as the main provider of foreign exchange revenues. To a large extent, this depends on industrial strategies and policies adopted by the government.

In the discussion below, we attempt to offer possible reasons for the low efficiency of productive capital and the absence of a vibrant private sector. We will consider the role of (1) an inhospitable policy environment; (2) a heavily intervened and poorly functioning banking system; and (3) the dominance of quasi-state actors, such as *Bonyads*.

Inhospitable policy environment State intervention in the economy has a long history in Iran. Evidence suggests that this interventionist stance proved more detrimental in the wake of the first oil boom in the 1970s. In much of the developing world, ISI policies were systematically dismantled in the late 1980s. In the case of Iran, international isolation and the Iran–Iraq war tended to strengthen the interventionist stance. The peculiar political economy interests that emerged from the revolution have also inhibited economic reform. Nationalization of the private sector after the 1979 Islamic revolution, import compression and overvalued exchange rates during the war years also proved unhelpful. Taken together, these interventionist and inward-looking policies created an inhospitable environment for private sector development.

In the pre-revolution era (1963–79), Iran followed the fashion of the time: import substitution policies (ISI). Growth of private enterprises during this period was mainly a result of government protection and subsidies. Thus, the investment process was directly or indirectly driven by the public sector. But, as with the experience of other developing countries, ISI policies were associated with rent-seeking and corruption – problems that intensified after the first oil boom. Against the backdrop of ISI policies and pervasive government intervention, a sudden increase in oil prices led to a policy and institutional collapse. The ISI policies pursued during the 1963–79 period had the paradoxical effect of increasing the economy's dependence on the oil sector. At the same time, the highly protected manufacturing sector, which grew rapidly behind tariff walls, did not have the incentive to export, nor did it develop the efficiency required to compete in international markets (see Karshenas, 1990: ch. 7; Pesaran, 1992).

Private investment received a major blow after the 1979 revolution. A significant part of the industrial and banking sector was nationalized and transferred to the public sector. The state's control extended to all major sectors of the economy. This not only squeezed the private sector, but also resulted in unproductive investments. But, perhaps more importantly, the policy environment continued to deteriorate after the revolution. The policy of import compression introduced as a response to foreign exchange shortages after the Iraq war and the introduction of various forms of subsidies strengthened the protection given to the domestic manufacturing sector. At the same time, import restrictions affected private sector growth. The effect of a prolonged war with Iraq and continued western sanctions against the regime is that Iran has become more inward looking over time. This has had a further debilitating effect on the private sector.

Another factor producing a distorted policy environment was the system of multiple exchange rates during the war years. Iran had two exchange rates until 2002: an official exchange rate that was accessible to government departments, connected firms and individuals; and a black market rate that applied to the rest of society. As Figure 4.8 shows, the gap between official and black market exchange rates was sizeable. This became a source of several economic distortions. It contributed, for instance, to the opacity of public sector accounts, as state-owned enterprises were allocated foreign exchange at the official rate. The exchange difference constituted a hidden subsidy for these organizations, and unlevelled the playing field for private sector firms. The overvalued exchange rate that resulted from this multitier system further harmed the competitiveness of the private sector.

Politicization of financial and monetary policies Coupled with a relatively loose fiscal policy, Iran has had a high rate of credit expansion. This has resulted in excessive growth of monetary assets and unprecedented levels of inflation. Iran's financial and monetary policies are ultimately driven by the demands for political redistribution. Over time, Iran's financial sector, which is largely state owned, has become a

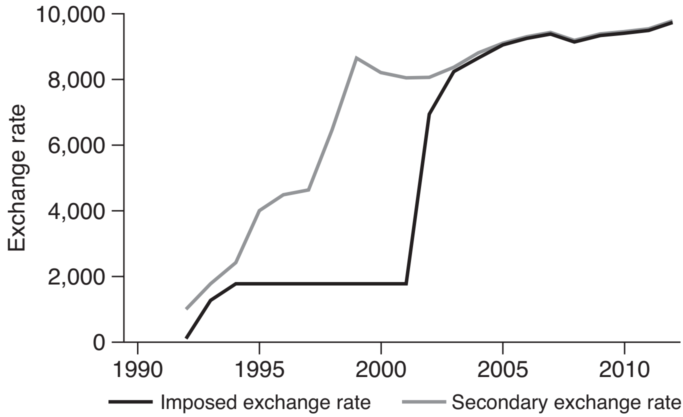

Figure 4.8 Official and black market exchange rates (rials per US$).

major conduit for transferring oil rents to chosen groups in society. Iran is perhaps one of the very few countries that are still subjected to a state of financial repression. Bank lending rates have remained well below the inflation rate. The government and the central bank have proved incapable of controlling the rate of credit expansion under political pressure from different interest groups. For example, the influential semi-public corporations have preferential access to credit. Monetary authorities face consistent political pressure to extend subsidized credit to favoured groups. In 2007, the President directed the banking system to lower lending rates to 12–13 per cent.

Under direction from the government, low-interest loans are extended to agriculture, tourism and small businesses. It is not clear whether this concessionary credit is used to expand productive opportunities or is simply recycled through the banking system to earn a high interest premium. The subsidized credit is allegedly subject to abuse. Regardless of the use these subsidized loans are put to, overexpansion of bank credit to preferred sectors and inefficient loss-making enterprises has become a major source of economic instability, fuelling inflationary pressures and compounding macroeconomic problems. This stems in part from the central bank's inability to exert appropriate supervision and control over credit expansion under pressure from different interest groups.

Given the high levels of inflation, real interest rates remain low, implying a weak relation to the scarcity of capital that prevails in Iranian economy. The politicization of the banking system has resulted in an excessive growth in money supply. Between 2003 and 2007 alone, the rate of domestic credit expansion has increased from 30.3 per cent to 41.6 per cent per annum. Lax credit policies have led to limited banking competition, low profitability of the banking system and inadequate mobilization and inefficient allocation of savings. Lack of robust competition renders these banks inefficient, pushing up the cost of capital for the private sector.

Role of Bonyads and other charitable organizations An important new element introduced in the post-revolutionary period was the greater involvement of the public sector in industrial production. This is reflected in the growing prominence of semi-public organizations, known as *Bonyads* or religious charities. The principal rationale of these charitable organizations was to meet the ideological needs of the Islamic state, with the promotion of distributive justice as one of its avowed aims. Although their primary objective is to advance the welfare of the poor, they have gradually turned into private monopolies that survive on state patronage. *Bonyads* can arguably be described as disguised state-owned enterprises.

Over time, these charitable organizations have turned into a key instrument in Iran's populist macroeconomic policies. Their legal status is not well defined: they are neither public organizations nor fully private. Given their charitable status, the *Bonyads* are eligible for an entire gamut of state favours, giving them an edge over other private organizations. *Bonyads* receive budgetary transfers; they are exempt from taxes and have preferential access to bank credit and foreign exchange at below market rates.

No wonder these charitable organizations have increasingly dominated private economic activity, operating in every conceivable business. A notable feature of these organizations is their opacity. Very limited information exists on their business operations, investment strategies and associated investment returns. Although it is hard to get precise estimates, it is believed that there are more than 300 such organizations. In the 1980s, their budget was equivalent to nearly half the total national budget. The largest charitable foundation is the Foundation of the Oppressed and War Veterans (MJF). The MJF has over 200,000 employees, 350 subsidiaries and an estimated value of US$3 billion, which is equivalent to 10 per cent of Iran's GDP. During the period 1981–90, government resources allocated to the foundation increased at an annual rate of 29.3 per cent (Wiig, 2009).

The *Bonyads* operate under the auspices of Iran's Supreme Leader and evade regular parliamentary oversight. They also evade all forms of supervision, accountability and independent financial audit. They are scrutinized neither by the government nor by shareholders. Ideally, the budget of semi-public foundations should be presented to the parliament as a supplement to the government budget with their credit position with the banking system separated from the accounts of the proper private sector. But this is rarely done. There is a serious lack of information regarding the functions and performance of these organizations. Their accounts are not publicly disclosed and, in the absence of credible data, it is almost impossible to evaluate the costs and benefits of their various programmes. It is not known, for instance, how well targeted their assistance programmes are. Shortage of credible and independently verifiable data on these organizations precludes an objective assessment of their programmes.

During the 1990s, *Iran's Revolutionary Guards Corps* (IRGC, or *Pāsdārān* for short) has emerged as another significant economic player. The *Revolutionary Guards* are an offshoot of the Iranian Army, created after the 1979 revolution. Like the *Bonyads*, the IRGC enjoys an extralegal status that affords them indemnity from public scrutiny as well as taxes. This new military–business complex controlled by the *Guards* now enjoys considerable economic and financial muscle. The Guards' foray into economic activity can be traced back to the end of the Iraq–Iran war, when one of the military's construction agencies, the *Khatam-ol-Anbiya* (KOA), was converted into a commercial entity and provided a wider role for post-war reconstruction. The KOA is now slated to be the third wealthiest conglomerate in Iran, with about 60 subsidiaries and 35,000 employees. The conglomerate has growing business stakes in the construction, engineering and telecommunication sectors (Wiig, 2009).

Enjoying strong ties with the core clerical state, *Bonyads* and *Pāsdārān* have both thrived under state patronage. Their growing control of the market and their preferential access to state favours prevent the emergence of a truly private sector. They undermine competition and distort private incentives for wealth generation. The economic activities of these quasi-state actors may hold the key to explaining the notoriously low efficiency of investment in Iran. The commercial and charitable functions of these foundations, although said to be formally separate, are not compatible with the aims of economic efficiency and commercial profitability. In the last decade, *Bonyads* are also believed to have been important obstacles to economic reform, as they represent powerful political and economic constituencies in the Islamic Republic.

Perhaps more importantly, these charitable foundations provide an interesting window into the workings of Iran's distinct political economy. They are a product of the country's dualistic power structure and a manifestation of the financial influence that Iran's unelected core state enjoys. The *Bonyads* and *Pāsdārān* serve as convenient conduits for distributing state favours and public employment to ideological supporters of the regime, many of whom are drawn from lower socio-economic groups. In this milieu, these charitable trusts help to consolidate political authority. They have become important tools for the socio-economic mobility of the lower and middle classes who had previously supported the revolutionary regime (Saeidi, 2004).

The dominant role of *Bonyads* has not been challenged by the privatization process. Some assets of these charitable organizations have been privatized, but this has not dented their economic clout. In some instances, they have in fact been beneficiaries of the privatization process: shares of national companies undergoing privatization have also been sold to *Bonyads* and *Pāsdārān*. Even if successfully privatized, the lack of credible information on these organizations will hamper accurate perception formation of investors and market participants, including those in the stock market.

4.5 The political economy of oil

The preceding sections demonstrate the central role of oil in shaping Iran's economy. It is clear that the core aspects of macroeconomic policy – be it budget spending, public finance, investment or savings – are ultimately determined by what happens in the oil markets. Superficially, with regard to the broader effects of oil specialization, Iran is no different from other resource-rich countries. It shares many of the same pathologies of oil: an overextended public sector, insufficient taxation, pro-cyclical fiscal policy, low profitability of investment, a weak private sector and slow pace of economic reform, to mention a few.

Although oil's impact on Iran's economy is not too dissimilar from other resource-rich countries, the political economy processes that generate these outcomes are clearly different. A discussion of the effect of oil on Iran's development would therefore be incomplete without reference to its associated political economy. It is important to look beyond macroeconomic policies and their outcomes, as they are ultimately shaped by the underlying distributional conflicts in society. They can be partly seen as vehicles for distributing oil rents to favoured sections of society.

To clarify these themes, this section will briefly pose three inter-related questions: What are the specific political economy dimensions at work in Iran's case? How are rents from oil distributed to the wider society? Are there any major differences in the way Iran has responded to the two oil booms of 1970s and 2000s?

As suggested earlier in this chapter, the political economy of post-revolution Iran is crucially determined by the structure of the Iranian state. The two central pillars of Iran's power structure – the official elected state and the core clerical state – create an 'embedded factionalism'. This generates conflicts over the distribution of resources and becomes the political basis of macroeconomic populism, manifested through cheap credit, consumer subsidies and generous public spending. Expansionary monetary and fiscal policies in Iran can then be viewed as tools to resolve distributional tensions arising from the competing claims of powerful interest groups. These include, for example, urban consumers, public and private producers and groups associated with the religious establishment.

Iran's distinct political economy also provides a likely explanation for Iran's low efficiency of investment and its weak private sector. As discussed earlier, the bulk of investment in Iran is channelled through semi-public charitable organizations, such as *Bonyads* and *Pāsdārān*, which have amassed considerable economic muscle through state patronage without being subjected to market pressures. Given that their investment operations are largely non-transparent, it is difficult to provide a definitive view of how economically and socially efficient these investments are. These quasi-state actors are, however, important means for providing jobs, contracts and other material rewards to political loyalists, serving as instruments for transferring oil rents to supportive political constituencies. This is the political backdrop against which Iran's Islamic commercial conglomerates have come to acquire growing economic and financial clout.

One of the peculiarities of the oil-exporting economies lies in the fact that oil revenues can in some cases allow the capture of rents on a magnitude and for a duration that may be unsustainable in non-oil economies. Despite being a major oil producer, however, the scale of rent flows from oil falls short of its actual potential in Iran. This is mainly a consequence of the country's inability to increase its oil production in the face of persistent underinvestment in the exploration and extraction of oil resources. Despite this, oil revenues have historically served as the main source of government revenue. This has permitted distortions and rigidities in the economic structure to continue for a longer period than would have been possible without access to oil resources. A steady flow of oil revenues has helped to sustain a plethora of market distortions. Economic and financial repression, for instance, has run a longer course in Iran than in many other developing countries. Oil provides an important explanation for the persistence of these economic distortions.

We next turn to a brief discussion of how oil rents are distributed to the wider society. As the previous section has shown, Iran's ubiquitous business conglomerates that operate at the margins of the public and private sector are convenient means for channelling rents to various interest groups. The use of the financial system to allocate credit on preferential terms is yet another mechanism for transferring rents to political clients. Oil resources are also distributed more widely to society through a range of implicit and explicit subsidies.

In Iran, the oil rents are combined with regulatory rents, which emanate from excessive state intervention; say, for example, price controls, high trade barriers or the system of multiple exchange rates. Had it not been for oil, it would have been difficult to sustain these regulatory rents. Regardless of whether these rents originate in the oil sector or from misguided state regulation, they tend to benefit groups that enjoy preferential access to public resources. Over time, this has led to strong clientelistic ties that have reinforced and perpetuated the rent-generating activities of the state.[13]

Recent literature on rent-seeking has concentrated on the economic cost of this phenomenon: the opportunity cost of resources that are devoted to access such rents and the resources spent in lobbying for rent-generating policies. Earlier economic literature had concentrated on the static efficiency losses of these interventions, such as the misallocation of resources between different activities. In addition to these two sources of allocative inefficiency, however, are the dynamic inefficiencies that arise from the presence of supernormal profits in certain economic sectors, which tend to persist as a result of continued state protection.

Such dynamic inefficiencies can result in long-term economic distortions which, apart from directing resources to the protected sector, exert a detrimental effect on its productive efficiency. There is limited incentive on the part of producers in the protected sectors to rationalize their production and management methods, or to embark on inventive activities, which is essential for a successful integration of the domestic economy with the international market place. Although quantitative measures of these different sources of efficiency loss in the case of Iran are not available, the latter source of dynamic inefficiencies associated with rent-seeking can be particularly significant in the context of long-term economic development.

To sum up, the manner in which oil rents are accumulated and distributed deserves a more nuanced explanation. Relative to the extreme cases of bad governance in Africa and the Middle East, oil rents are not pilfered at source but captured in the process of distribution. Oil rents are distributed to a wide class of beneficiaries in Iran, many of whom hail from the middle and lower income groups. The problem in Iran, however, is less to do with the concentration of oil rents in a few hands, but more with the efficiency implications of the manner in which they are distributed.

4.5.1 Are policy responses different between the two booms?

Given the significance of natural resources and the associated political economy, it is pertinent to pose the following questions: Has Iran managed its latest oil boom any better than the one in the 1970s? Are there discernible patterns of continuity and change? We begin with the clarification that the two periods are not strictly comparable. For one thing, oil revenues have on average been lower in real terms and more volatile in the post-revolution period. Iran has also faced greater economic and political isolation on the international stage. Despite these confounding factors, a comparison of the two oil price booms appears to be useful.

At face value, oil price hikes in the two periods have not led to widely divergent macroeconomic outcomes. Oil booms in the 1970s and 2000s were both associated, for instance, with resurgence in economic growth. Both periods witnessed spending and investment booms. However, a comparison across the two periods presents a picture of both continuity and change. There is a surprising continuity in the interventionist stance: the state has continued to play an overstretched role in the national economy in both periods. Oil continues to dominate the Iranian economy, and macroeconomic policy remains largely pro-cyclical.

These apparent similarities mask considerable differences. Although the recent increase in oil prices has led to a resumption in economic growth, allowing Iran's GDP to grow by around 6 per cent annually, growth numbers are still considerably lower than those in 1970s. And if we consider the earlier period, 1962–71, Iran's GDP grew twice as fast. Unlike the 1960s, however, growth in the recent period has been accompanied by double-digit inflation rates. Investment performance has also differed across the two oil booms. There has been a collapse in the efficiency of investment since the inception of the 1979 revolution. The chaotic transition brought by the revolution and the destructive consequences of war with Iraq certainly had a role to play. But productivity did not pick up even after the war. The average annual productivity growth during the post-war decade was a mere 1 per cent, which is nearly four times lower than the corresponding figure for the pre-revolution period (Mojaver, 2009).

Although the government followed a strategy of import-substituting industrialization behind high tariff walls and other protectionist barriers in both periods, there are significant differences between the two periods in terms of institutions and agents of accumulation. Clearly, the underlying political economy is radically different across the two oil booms. Compared with the centralized political dispensation in the 1970s, twenty-first-century Iran operates under a dual power structure, where the unelected core state commands vast economic resources and engages in widespread political redistribution. There are also critical differences in the resource allocation mechanisms. During the second oil boom, Iran has witnessed a growing share of current expenditures, especially on subsidies and other fiscal transfers, but a falling proportion of development spending. Economic controls are more extensive in the second period, although these are partly a response to an adverse external environment.

Importantly, the nature and demands of political redistribution are different in post-revolutionary Iran. Credit subsidies and parastatals have assumed a growing significance in the second boom. In a divided power structure, oil has intensified populist policies and fuelled greater factional competition for resources, leading to a different configuration of elites. Bazaar merchants, religious elites and political factions within the state have now gained increasing prominence. The Islamic Republic needs to cater to a wider constituency, with the result that the base for rent distribution is arguably wider than the centralized technocratic structures of the 1970s. However, it is also associated with greater economic inefficiency than in the 1970s.

Oil has not been an unmitigated disaster for Iran; it has facilitated progress on several fronts. Even if fundamental reform has been difficult to introduce, there have been some notable advances. For example, the adverse effects of the oil windfalls in the 1970s did generate some social learning. As a result, the fiscal response was slightly better, with Iran achieving a more balanced budget and a relatively higher government saving. Despite facing significant obstacles, the economic reform programme in the 1990s was successful in dismantling some economic controls and introducing privatization. Two areas of relative success have been the unification of the exchange rate and the setting up of an oil stabilization fund (OSF) in 2000 intended to smooth out the effect of oil revenue fluctuations on government expenditure.

The need for the OSF was driven home by the painful experience of the boom and bust episodes in the early 1990s and the extreme vulnerability of the regime in the face of international isolation. The OSF accumulates above-budget receipts and, as noted earlier, it has yielded some respectable savings. One of the aims of the OSF is to strengthen the non-oil private sector: up to half the fund can be used to promote private sector exports in the non-oil sector. These noble objectives apart, the OSF is frequently 'raided' to meet current spending needs.

Learning from the experience of the 1990s, Iran has utilized oil revenues to write off expensive public debt and unify exchange rates. The more conservative fiscal stance of the government relative to the early 1990s, combined with a sustained increase in oil prices, paved the way for exchange rate unification by the Central Bank. Iran has also made massive investments in education, resulting in an increase in the literacy rate from 43 per cent in 1975 to 75 per cent in 1996. Surprisingly, oil has facilitated critical reforms in both periods. In the pre-revolution period, oil windfalls helped the successful execution of land reforms, and in the post-revolution period, oil facilitated the unification of exchange rates. In the arena of international trade, quantitative restrictions were replaced by equivalent tariffs, although average tariff rates remain some of the highest in the Middle East.

4.6 Concluding remarks

This chapter has attempted to develop a political economy narrative of oil and development in the Islamic Republic of Iran. Iran was the first country in the Middle East to discover oil, and it is the fourth largest oil producer in the world. Oil exploration and extraction has, however, slowed down since the 1979 revolution. In this regard, four factors have played their hand adversely: the imposition of US sanctions, war with Iraq, growing domestic demand for fuel and Iran's inflexible contracting arrangements. The unfortunate result of this has been a chronic underinvestment in the oil sector. Presently, Iran finds it difficult even to maintain existing levels of oil production. Although production shortages are a serious concern, government commitments regarding oil contracts are generally credible, and oil revenues are publicly disclosed with relative transparency. There is no evidence of any large-scale diversion of oil resources at source.

There is no simple linear explanation for how oil has shaped Iran's development trajectory. Iran has had a varied development experience, with periods of growth as well as regression. In the period preceding the first oil boom in the 1970s, Iran witnessed a 'comprehensive' programme of economic and social modernization, dubbed by the government as the 'white revolution'. This was a period of sustained growth, enabled by land reforms and massive investments in physical and human capital.

The oil shock in the 1970s, however, disrupted Iran's economic advance and subjected the development strategy of the 1960s to a severe test. The oil shock led to an erosion of the quality of governance and a collapse in macroeconomic management. In the face of oil windfalls, the quality of spending deteriorated, building up strong inflationary pressures. The centralized development strategy under the Shah, combined with the substantial oil windfalls in the 1970s, subverted the authority of the government technocrats precisely at a time when measured and rational decision making was essential.

The 1979 revolution brought a dramatic change in the external and domestic context of Iran. Internationally, the country faced growing economic and political isolation. The ensuing war with Iraq and a slump in global oil prices further weakened Iran's position. In the face of these adverse external circumstances, Iran became more inward looking, extending its reach to all areas of economic activity. The Islamic regime introduced a new *dirigisme* that involved nationalization of the banking, industrial and services sector and a series of direct market interventions.

However, the most far-reaching consequence of the revolution was political, not economic. The structure of the Iranian state that emerged after the revolution involved a duality of power structures in which the elected official state cohabits with the core clerical state. This multiplicity of power centres creates an inherent factionalism that can sometimes lead to intense competition for resources. This is the political backdrop that mediates oil's impact on economic development. Oil remains a central driving force in the Iranian economy. It is the principal source of foreign exchange, government revenue and savings. No wonder, then, that developments in oil markets shape the workings of the Iranian economy in a profound manner.

The central budget is the principal medium through which oil revenues are expended. Higher oil prices have frequently led to spending booms. The result: volatility in the oil markets is often reflected in the volatility of budget spending. This correlation between the central budget and oil prices is further strengthened by a weak tax effort. The share of taxes in GDP is both low and declining. Macroeconomic policy has become more populist in nature, reflected in the growing share of current expenditures in the central budget. A range of explicit and implicit subsidies is used to pass on the oil rents to consumers and other special interest groups.

We next analysed the effect of oil on savings and investment behaviour. A key finding here relates to a high and rising savings rate. A favourable demographic profile, with the active labour force forming a growing share of the population, provides one explanation for this high savings rate. Investment rates have also been quite substantial, especially since the mid-1990s. These high savings and investment rates, however, do not translate well into economic growth. Putting together the figures on growth, savings and investment reveals one of the most striking findings on Iran: the low productivity of investment. There is strong evidence to suggest that Iran has witnessed a collapse in the efficiency of investment, especially since the advent of the revolution. The problem in Iran is not one of low investment levels, but unproductive and inefficient investments. For much of the past thirty years, total factor productivity in Iran has been either negative or very low.

The low efficiency of investment is even more puzzling in the face of two further trends: (1) the growing share of the industrial sector in GDP; and (2) a high proportion of private investment in aggregate investment. This begs the question: Where has all the investment gone? A closer inspection can help to reconcile the facts on investment with reality. First, even though the industrial sector has grown in size, the manufacturing sector has a relatively insignificant presence in the Iranian economy. Second, the distinction between public and private investment is blurred in Iran. A significant part of the private sector is simply an extension of the 'core' and 'unaccountable' state sector. So, what goes around as private investment is essentially neither private nor public investment in the normally understood sense of these terms. For example, investment by Islamic conglomerates of *Bonyads,* which is sometimes referred to as private investment and sometimes as disguised public investment, is neither subject to public sector transparency and accounting rules nor akin to arms-length and taxable private sector activities.

The issue of investment efficiency is closely related to the nature of the investment process, especially the operations of commercial charitable organizations, such as *Bonyads* and *Pāsdārān*, which draw considerable financial and political support from Iran's religious establishment. The investment operations of these parastatals are largely non-transparent. For one thing, very little is known about the nature and returns on their investments. Their legal status grants them immunity from taxes and public disclosure. Rather than acting as profit-maximizing agents, these conglomerates thrive on state patronage. The phenomenal rise of these parastatals might have come at the expense of private entrepreneurial activity. They unlevel the playing field and erect entry barriers for younger and smaller firms.

A proper analysis of investment and spending decisions, and more generally macroeconomic trends, is complicated by Iran's dual political structure. Many of Iran's pressing economic problems – whether it is populist macroeconomic policies, abuse of the financial system, low efficiency of investment or economic distortions – have their basis in the political economy. The state's control of the banking system, its exchange rate policies, the use of direct and indirect subsidies and the operation of Islamic charities are all different mechanisms for political redistribution. The *Bonyads* offer a particularly dramatic illustration. These semi-official commercial ventures can be viewed as vehicles for distributing oil rents in the guise of credit, contracts and jobs to political clients. They offer valuable opportunities to incumbent religious elites for economic and political entrenchment.

Iran offers an interesting case where rents are captured not at their source but in the process of distribution. Arguably, such redistribution does not just line the pockets of a few. It trickles down to some wider segments of society, including those selected from the lower and middle rungs of the income ladder. But this can have grave implications for efficiency and can even compromise equity in the long run – for example, by refusing equal opportunities and a level playing field to aspiring small or young firms.

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Notes

1 A closer inspection of economic cycles – and of boom and bust episodes – reveals a strong association between oil prices and growth fluctuations in Iran. For more detailed evidence on this, see Hakimian (2008), Karshenas and Hakimian (2005: 72–74) and Farzanegan and Markwardt (2009).

2 Figures from the 2006 World Development Indicators.

3 The corresponding figure for the Middle East and North Africa region is 0.36. http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/ENVIRONMENT/EXTEEI/0,,contentMDK:20872280~pagePK:210058~piPK:210062~theSitePK:408050,00.html.

4 The statistics on mining resources are based on Economist Intelligence Unit (2008).

5 Privatization sat uneasily with Article 44 of the constitution, around which forces opposed to privatization congregated. The *Expediency Council* announced a re-interpretation of Article 44 in 2004 with far-reaching effects. According to the new interpretation, all government enterprises, including heavy chemicals and petrochemicals, telecommunications, electricity generation and all the downstream activities in oil and gas, mining, banking and insurance, etc. are to be privatized.

6 Own calculations based on data from the Central Statistical Office.

7 The sanctions apply to any company investing US$20 million or more per year in an Iranian project.

8 Furthermore, despite rising oil prices in international markets, the domestic price of oil has not been adjusted upwards. The fiscal burden of explicit oil subsidies has therefore grown.

9 Implicit subsidies for the domestic users of natural gas alone account for approximately 9 per cent of GDP.

10 Iranian national account statistics are measured on production and expenditure sides and do not report the income side. Aggregate national savings are derived as a residual, and should therefore be treated with caution, as residuals could embody substantial measurement errors.

11 Data based on reports from the Central Bank and the Central Statistical Office.

12 The incremental capital output ratio (ICOR) also reduced from 5–6 per cent to approximately 2.5 per cent (IMF, 2004).

13 It is important to note that government subsidies that are introduced on economic grounds, e.g. on grounds of economies of scale and learning, need not generate any rents in the private sector, as subsidies of this type are supposed to make enterprises, which would otherwise be loss making, become viable.

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