

## **Iran's Post-Sanctions Economic Challenges**

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### **Abstract**

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*Lifting of economic sanctions is a necessary condition for Iran's economy to grow. It is not sufficient, however. Iranian economy has been suffering from structural problems caused by the wrong role of the state. Using Phillip Cerny's concept of government as provider of three types of "public goods," here we argue that government should move away from being a direct producer and become a regulator. There must be compatibility between economy and polity. Iran's economy, similar to many others, needs transparency, rule of law, and respect for privacy. In other words it needs democracy. By briefly looking at the history of government's economic policies we show that inability to make such transformation was the major cause of the 1979 Revolution. Since then things have gone worse and unless some major reforms take place the lifting of sanctions will not cure Iran's economic problems.*

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### **I- Introduction**

Implementation of the nuclear deal<sup>i</sup> that Iran and 5+1 signed is supposed to result in lifting of specific economic sanctions<sup>ii</sup> on Iran. No serious observer considers such a lifting of sanctions to have a major immediate impact other than a psychological one, and easing some of the financial restrictions. Many high level delegates from public as well as private sector of major economies of the world have travelled to Tehran or are planning to do so. There have been talks about a number of investment projects, but no major concrete action has taken place as of yet. It would be a mistake to think sanctions have been the only, or even the most damaging factor that has pushed Iran's economy to the verge of collapse. The real trouble is the structure of Iranian economy and the role that state (political apparatus) plays in it. Some of these problems predate Islamic Republic (IRI) and the 1979 Revolution. But IRI has exacerbated them tremendously.

### **II- Background**

Iran's attempt to modernize/industrialize its economy started in the mid19<sup>th</sup> century under Amir Kabir. Constitutional Revolution of 1907 was a major step forward towards modernization of Iranian society. The social and economic (but not political) attempts to modernize Iran started in earnest with Reza Shah's reign in 1922. In those days there were no modern institution and it would make sense for the state to provide for all major requirements such as infrastructure. For example a railroad that linked Persian Gulf in the south to Caspian sea in the north via capital Tehran in particular was very helpful. Establishing a national/central bank (Bank e Melli) was also crucial. At this point Iran was not different from other countries that start the process without any modern infrastructure, including a developed market structure. State has to be provider of "productive/distributive" public goods. According to Cerny<sup>iii</sup> this "involves specific state-controlled or state-sponsored activities of production and distribution...Among these are full or partial public ownership of certain industries, direct or indirect provision of infrastructure and public services, direct or indirect involvement in finance capital, and myriad of public subsidies."

At early stages of development, sustenance of a rapid rate of economic growth requires well-organized and centralized allocation of resources towards investment, mainly in infrastructure and basic industries. This is, necessarily, against immediate consumption. Under market mechanism resource allocation is decentralized. Besides, at this early stages markets are usually undeveloped, thus insufficient as well as inefficient. There is little choice for government but to become the main agent of resource allocation, i.e. provider of productive/distributive public goods. These governments, usually self-appointed, but even if elected, are generally authoritarian.

This is in accordance with, and arguably necessary for a forced allocation of resources. At this stage institutions of modern civil society<sup>iv</sup> are non-existing or under developed. Also missing is a strong sense of citizenship associated with the modern nation state. Therefore there is little pressure on the state apparatus to act democratically; that is to provide "regulatory" public goods."

A normal process of economic development, past this "primitive accumulation" would have been for the state to reduce its direct involvement in the economy, leave "resource allocation" decisions primarily up to the market (entrepreneurial private sector) and be more provider of "regulatory public goods" that "include the establishment and protection of private (and public) property rights, a stable currency, the abolition of internal barriers to production and exchange, standardization of weights and measures, a legal system to sanction and enforce contracts and to adjudicate disputes, a more specific regulatory system to stabilize and coordinate economic activities, a system of trade protection, and other systems that could be mobilized to counteract system-threatening market failures." This means state must become a consistent observer of rule of fair laws (representative democracy), and show respect for privacy and individual freedoms of citizens (human rights). It is not accidental that, as a rule, advanced market economies are democracies and their governments have a relatively higher respect for individual freedoms and human rights of their citizens. The compatibility between polity and economy is required for further development. State must evolve and match the needs of economy (an entrepreneurial private sector). This did not take place in Iran. The challenge was not felt until 1975. The main culprit that enabled state to continue the "old ways" was oil revenues. State did not need private sectors and its tax revenues. Indeed it became the other way around. It was the "private sector" that relied more and more on state subsidy. Iran was suffering from a severe case of Dutch Disease. For fifty years the state was major allocator of resources. Using oil revenues it would decide, based on its political priorities, rather than market's profit motives, where to allocate resources. Not all went bad. Iran's "Five Year Development Plans" made some progress. Iran's third plan (1962-1968) emphasized industrialization and support for private sector. It provided investors with cheap credit and encouraged foreign investment. The problem was that recipients of these, and other favors and subsidies were not selected primarily based on economic criteria. Connection to the state apparatus, particularly royal family, was more significant. This encouraged nepotism and corruption. Nevertheless, there were tangible results. State's direct investment in roads, highways, dams, bridges, and seaports increased noticeably. Joint public-private projects in agricultural sector also attracted significant foreign investment. Many large-scale agribusinesses in meat, dairy products, and fruit production were established. Small-scale farmers, however, did not benefit from the new investment opportunities.

The fourth and the fifth development plans were even more successful (1968-73; 1973-78). Assisted by a combination of increased oil revenues, public spending, and foreign and domestic investment, Iran's gross national product grew at an annual rate of 13.2 percent at constant prices during the three plans (1964-1978). A private sector, and rather affluent and modern middle class (necessary ingredients for a strong civil society and viable democracy) were taking shape. Between 1973 and 1978 oil prices quadrupled. The 1973 Arab Israeli war, and OPEC's decisions enabled Iran to increase investment by an average of 56% per year<sup>v</sup>.

By now Iran's economy had reached a level that a significant and structural change in the role of state (moving away from "productive" to "distributive" public goods) was crucial for further advancements. Market (private sector) and entrepreneurs that would consider excessive involvement of state in the economy a negative and obstacle were on the rise. State's interferences, accompanied by nepotism and corruption in which royal family, particularly younger princes and princesses, would prevent market mechanism from doing its job. Perhaps more significant was the rapid increase of the modern middle class, and their demands for respect for individual freedom and privacy.

### **III- 1979 Revolution and Islamic Republic**

Iran's 1979 Revolution was not "Islamic" in the sense that its main demands were not restoration of traditional cultural values. "Islamists" took over and consolidated their power in a sometimes bloody and brutal power struggle that took a few year. In the end they won and implemented their cultural ideology in what is today's Islamic Republic of Iran. From the above it should be clear that poverty and lack of economic opportunity were not a factor in revolution. Demand for individual freedoms by the middle class, and reduced role of state in public life (particularly that of the notorious secret police SAVAK) was the main reasons for the 1979 Revolution.

If anything, the revolution tilted state-economy's relation more towards state. In addition to high ranking officials of the last regime, including many with knowledge of modern economy, almost all captains of industry and commerce fled from Iran for fear of retribution.

In fact out of few who did not/could not get out of country almost all were executed. Suddenly state was in charge of all major economic enterprises. In addition to owners, most of high ranking manager with expertise had also left. There was no one able to replace them. They were replaced by (mostly young) revolutionaries whose credentials were number of years that they had fought against Shah's regime.

The long and costly war with Iraq that began with Saddam's invasion of Iran in 1980 forced a "war economy" that further increased state's control of economy. Governmental and pseudo governmental institutions (religious and non-religious "foundations") controlled  $\frac{3}{4}$  of Iran's economy. The other  $\frac{1}{4}$  heavily depended on the state for its survival.

The mix of three decades of suppression and propaganda against modern institutions by a state that has had little incentives to bring meaningful political openness is one dimension of the problem. State's control of substantial oil revenues and its consequent financial independence that has reinforced the lopsided relationship between state and society is another. Control of state apparatus, therefore, has become a high priority for all people and forces with a social agenda, not to mention ambitious and greedy ones. Pre-modern forces and institutions have learned that control of the powerful state apparatus enables them to achieve their goals, even though these may suffer from lack of public support. Consequently, they have become resourceful in hiding their backward nature. Therefore Iranian society, which is in many ways modern, faces a pre-modern state that is savvy in using modern means to continue its existence and push its agenda. For example, one characteristic of pre-modern is existence of a number of warlords with their regional "governments" in the geographic space of the country. With one exception<sup>vi</sup>, this is not the case in today's Iran. However, there are a number of power centers in the social space of capital Tehran alone that for all practical purposes act as autonomous governments. They each have control over a segment of armed forces and militia, have their own financial sources, and their own foreign minister! In addition to the official government (the executive branch headed by the president) the "independent" judiciary branch is practically another government. The Supreme Leader's office is more or less accepted by many as "the real" government. Revolutionary Guards have their own financial empire and governing apparatus. They control ports of entry to the country. This enables them to import goods, some of them banned, duty free without even being registered and/or recorded. Thanks to the Guards support, foreign made cigarettes; tea, rice, and similar items are plentiful in the street of Tehran. The Commerce ministry has banned or limited their imports of these items in order to protect domestic producers.

While existence of shadow government(s) is not unique to Iran, their extent, scope and number are unprecedented. Equally important is the fact that these networks are formed on the basis of pre-modern social relations and concepts such as clan or geographical proximity. They could be formed around official and seemingly legitimate institutions, religious foundations, or simply a high ranking clergy and statesman. Membership in many occasion is a 'birth right' and seldom is acquired on a "merit" basis. "They reflect a symbiotic relationship between the ruling theocratic oligarchs and their business supporters in the bazaar. Unlike the case in advanced liberal democracies where such unregistered activities are closely watched and the unlawful segment diligently dealt with, Iran's politico-judicial authorities knowingly or otherwise spawn and nurture them by either tolerating or only selectively punishing some of their glaring indiscretions."<sup>vii</sup> The new nomenclature (Aqazadeha, children of the ruling clergy) has monopolized foreign trade, and is exclusive distributors of imported items in domestic markets. Corruption is rampant. The worst offenders are the numerous "non-profit" foundations controlled by the above mentioned power centers.

#### **IV- Iran's economy suffers from Wrong policies and Bad Politics**

Iran's economy suffers from bad economic policies also. This was particularly true during Ahmadinejad presidency (2005-2013). Money supply, for example, quadrupled in that era. Close to \$700 billion mainly oil revenues were squandered, \$300 billion of it unaccounted for. When Iran came to negotiating table in 2014 it was suffering from a severe stagflation, while a 44% annual rate of inflation and negative 6.8% rate of economic growth.

No doubt various sanctions imposed on Iran have had a significant negative effect. But these sanctions are mainly consequences of wrongheaded foreign policy of IRI. Although some of these sanctions are as old as Islamic Republic itself, it was Obama administration that made Iran feel the pinch. Obama's doctrine of reliance on diplomacy, a response to disastrous outcome of invasion of Iraq and Afghanistan war of its predecessor, has convinced him that "Iran problem" does not have a military solution.

But hardliners in charge of IRI's foreign policy would not come to table, partly due to mistrust and mostly because they did not want to let go of their anti-American rhetoric that has become their identity. To force IRI to negotiation Obama administration extended and intensified the sanctions to an unprecedented level. This was partly due to wrongheaded attitude of IRI leaders (president Ahmadinejad repeatedly said sanctions are not worth the paper they are written on). It was mainly due to diligence, persuasion, arm twisting and threat of Obama administration that the sanction system was so comprehensive and effective. So the IRI leadership decided to negotiate with Americans, first in secret in Oman and later, after election of president Rouhani, openly.

#### **V- Who will be affected by the Deal?**

The deal is much more than curbing Iran's nuclear ambitions. It is a first step in bring back IRI from a pariah state into a normal member of the global community. This makes neocons and all those in favor of a more militaristic foreign policy in the US nervous because they lose a good "excuse." Same is true for BB Netanyahu and extreme right in Israel that will be denied this "existential threat." The hardliners in Saudi Arabia and other regional countries will not be happy either. Russia and China, too, will lose an economic bonanza, and an occasion to demand favor from US and its allies in return for using their leverage to keep IRI from causing trouble.

Hardliners in Iran, those who still dream of "exporting Islamic revolution" are very much oppose to this deal also. In short, it seems everybody loses from IRI stopping to be a bogeyman. Who benefits? As was said If IRI leaders decide to make Iran's national interest, rather than their own internal and external "Islamization" agenda, top priority, they will find out that a normal relation with the US benefits both countries. Iran and the US share many common interests. Some, such as support for Iraqi and Afghani governments, or fighting against ISIS and Taliban, are obvious and publicized. Less publicized is the daily contact and cooperation between Iranian and US navies in the Persian Gulf. This is a shallow body of warm water full of marine life. If one of the giant oil tanker carrying hundreds of thousand tons of crude oil is sunk in it (something that terrorist groups must be dreaming of everyday) an environmental catastrophe is in hand. For years that has not happened thanks to the coordination between the two navies. Major challenges to Iran's national interests do not come from the US, or Israel. They come from the north. Despite being the largest country of the world, Russia does not have practical and unimpeded access to open waters. Tsari Russia's quest for "warm waters" has resulted in cession of big chunks of Persian Empire in the past two centuries. Caspian Sea, the largest lake in the world, is full of resources. Other than oil and gas its caviar is famous. Before the collapse of Soviet Union it was controlled half and half by Iran and the Soviet Union. Now there are five countries there and they dispute Iran's claim to half or much water beyond its coast. The legal status of Caspian see is in limbo. Iran needs all the help that it can get in any relevant International organization or arena dealing with this issue. Another major challenge with huge upsides for Iran relates to the newly independent Asian republics of Soviet Union. They would welcome presence of US in the region as a counterpart to the heavy influence of Russia and increasingly China. These are land lock countries. The shortest, easiest (mostly flat terrain) way to access the rest of world is via Iran with its numerous roads and railroads.

The biggest benefits of this rapprochement for Iran and the rest of the world are in the realm of economics. Iran is a country of 75 million mostly young people with an above average of the region acquired taste for modern products and services. Its labor force, too, is higher than average in terms of education and dexterity. Thirty five years of various sanctions has made it in dire need of modern technology. It also has one of the lowest foreign debt ratios in the world, another consequence of the sanctions. To this one should add Iran's potential as a hub for access to several central Asian countries. Iran is the best transit route for exports, mostly oil and natural gas and minerals, of these to the rest of the world. All of these create potentials for hundreds of billions of dollar of investment and millions of high paying job for a country that is suffering from double digit unemployment.

#### **VI- What it takes?**

Lifting of sanctions is a necessity for Iran's economy to climb out of the hole it is in. But it is not sufficient. State's role must go through a drastic shift, from provider of "productive/distributive" to provider of "regulatory" public goods. Government should respect rights, including privacy of its citizens, and impose the rule of law, be transparent, subject all economic actors, including pseudo governmental "revolutionary" and religious foundations, to the same laws (of market if appropriate). In short it should move towards democracy and respect for human rights. Democracy and human rights are pre se of value and governments must value them. Additionally they are a needed for compatibility of economy and polity. Once an economy reaches a certain level of development, its further advancement require a state that is compatible.

As is evident in case of almost all advanced economies, without an accountable, transparent democratic government that respects and implements rule of law economy cannot advance further. This was the case of Iran in late 1970s. Failure of state to adjust was a main factor in 1979 Revolution. Incompatibility has increased since then. Rouhani administration and its economic team are aware of this fact. The problem is that they have little power to make necessary changes. IRI's constitution gives a lot of power to individuals (Supreme Leader) and institutions (The Guardian Council) that are not directly elected, A large number of military and paramilitary institutions, security apparatuses, and religious foundations are semi-autonomous and act as state within the state. They oppose changes toward democracy. Only when economy was in the verge of collapse they grudgingly approved of negotiations. They believe keeping the status quo now is feasible and preferable. Unless proven wrong they will resist any major change. Proving them wrong could be a very costly endeavor for Iranian people and economy.

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<sup>i</sup> For a detail explanation of the "deal" please see: <http://www.vox.com/2015/7/16/8974507/iran-deal-explained-expert>, and <https://news.riskadvisory.net/2015/16/iran-summary-of-nuclear-deal>.

<sup>ii</sup> A good explanation of these sanctions could be found at: [belfercenter.ksg.harvard.edu/files/Iran Sanctions.pdf](http://belfercenter.ksg.harvard.edu/files/Iran_Sanctions.pdf)

<sup>iii</sup> Philip Cerny, "Globalization and Collective Action," *International Organization* Autumn 1995, 49(4), pp. 595-625.

<sup>iv</sup> Civil society has been defined in a number of ways. Here we have the broadest concept in mind. Houshang Amirahmadi, "Emerging Civil Society in Iran," *SAIS Review* Summer-Fall 1996, 16(2), pp. 87-107

The word "modern" is emphasized to remind readers that in many cases there is a traditional civil society, which is, like other aspects of pre-modern societies, dominated by religious institutions.

<sup>v</sup> [http://lcweb2.loc.gov/frd/cs/pdf/CS\\_Iran.pdf](http://lcweb2.loc.gov/frd/cs/pdf/CS_Iran.pdf).

<sup>vi</sup> The exception is Khorasan province and Imam Reza's (the 8<sup>th</sup> Shia Imam) foundation (Astan e Qods e Razavi)

<sup>vii</sup> Amuzegar, J. Iran's Underground Economy. *MEED* Sept. 08, 2003. Reprinted from [www.marzeporgohar.org](http://www.marzeporgohar.org)