

DRAFT

Institutional Change, Policy Challenges and Macroeconomic Performance: Case Study of Iran (1979-2004)

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Hassan Hakimian*

* Senior Lecturer in Economics and Associate Dean at Cass Business School, City University, London.
(H.Hakimian@city.ac.uk).

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1. Introduction

Iran offers unique insights and rich rewards as a case study of growth and development in the context of fast changing economic and socio-political environments. Since the Revolution in 1979, Iran has witnessed important socio-economic and institutional changes and has been affected by significant economic and political upheavals. The macroeconomic scene, in particular, has experienced a number of major shocks including oil booms and busts, war with Iraq, trade sanctions, and internal political uncertainty – all affecting long-term accumulation and growth.

Despite Iran's manifest resource riches both in human and natural forms, the record of the post-revolutionary period is lackluster with many Iranians experiencing a considerable setback to their living standards by regional and international standards.¹ It has been argued that in fact, Iran's ability to live off its oil rents has pushed back and delayed the agenda for economic reforms, at times obstructing the largely overdue modernization of Iran's ailing economy (Alizadeh, 2003).

This paper examines the post-revolutionary's macroeconomic policies and performance in a comparative context appraising it against Iran's past trends and real potential. The paper argues that two sets of factors have conditioned Iran's performance to date and are likely to continue to taint her prospects for sustainable growth into the future. These are: Iran's lack of economic diversification and continued dependence on the oil sector, on one hand, and the institutional setting in which post-revolutionary economic policies have been formulated and implemented for much of the last three decades, on the other.

The structure of the paper is as follows. First, we chart Iran's growth and development path, highlighting political economy changes that have taken place before and after 1979, and their implications for the model of growth and development pursued. Second, we examine a broad overview of Iran's comparative economic performance over the last few decades in regional and historical contexts. Next, we turn to a discussion of policy challenges and responses in three sub-periods after 1979. Broadly, these are: (a) 1980-88: (the war years); (b) 1989-93 (years of reconstruction and reform); and (c) 1994-2004 (the decade of austerity and reform). After this, we examine Iran's principal characteristics as an oil economy, and the way the agenda for economic policy and reform has been affected by the institutional setting prevalent in this period. The final section offers a summary and some concluding remarks regarding Iran's macroeconomic track record and the challenges facing it in the future.

¹ For a broad discussion and analysis of Iran's economy in this period, see: Hakimian and Karshenas (2000), Pesaran (2000), Behdad (2000), Mazarei (1996), Hakimian (1999), and Salehi Esfahani (2002).

2. Charting Iran's Growth and Development Path

Iran's recent past presents a rare – arguably a 'laboratory' like – case for the study of growth and development. In the span of nearly three decades after the 1979 Revolution, Iran has witnessed sweeping institutional changes and has been affected by significant economic and political upheavals. At the macroeconomic level, in particular, she has experienced a number of shocks ranging from oil booms and busts, to war (with Iraq), trade sanctions, and internal political strife – all affecting long-term accumulation and growth. These changes offer us unique insights into, and rich rewards for, a case study of growth and development in the context of fast changing economic and socio-political environments.

Two particular features of this case stand out with some distinction: the fact that Iran is a large, resource-rich country, and the character of the emergent post-revolutionary institutions which infuse atypically, religion with politics. These features add to the complexity and challenge confronting any study of Iran's recent past. Yet they also render it potentially more interesting from the point of view of their wider implications for growth and development.

The 1979 Revolution overthrew one of the most stable and enduring monarchies in the Middle East and North Africa (MENA) region backed by a large and modern army. Apart from its far-reaching implications for wider international politics (which is beyond the scope of this chapter), the Iranian Revolution was also momentous in two other respects. First, the revolutionary course was driven by one of the broadest and largest mass-based movements of the twentieth century and harbored with it high expectations of change for the supporting masses. Second, by installing the world's only theocracy in modern times, it has created an unfamiliar and unorthodox institutional and political setting, which continues to challenge conventional thinking to date.

Prior to Revolution, Iran was led by a variant of what may be described as a 'developmental state' (Alizadeh, 2000, pp. 17-8). The state had substantial autonomy from social groups and pursued policies that were conducive to the development of the private sector.² Moreover, as with other military dictators, the Shah had a strong commitment to growth, which he saw as the way to lifting the country out of a century-long poverty and underdevelopment. To achieve this, he implemented a wide-ranging program of social and economic reforms from above in the 1960s, and pursued an active import-substitution industrialization policy to accelerate capital accumulation in the 1960s and 1970s (Karshenas, 1990). Steadily growing oil incomes and a sizeable domestic market offered Iran more of an opportunity to emerge as an industrialized country by the 1970s. The advent of the oil boom in this decade, in particular, fostered this vision as it now seemed feasible to use the underground wealth to catapult Iran into a regional economic and military power.

Two obstacles, however, interfered with this course of development. First, was the weak, if not missing, domestic political legitimacy given the Shah's strong formal dependence on Western powers.³ Second, and no less important, was the uneven and highly differentiating impact of economic growth in these years, which heightened social tensions especially in urban areas (Hakimian, 1988: 19).⁴ These tensions were further fueled by the 1970s' oil boom, leading to much social and economic dislocation (Graham, 1978; Hakimian, 1990). When dissent and social discontent erupted into the open, the fact that all meaningful political channels had been extinguished in the previous decades was not a tactical advantage the regime could draw on. On the contrary, it helped channel all opposition into an effective mass movement effectively focused against the Shah.

² Its industrial drive was, however, oriented towards the domestic markets unlike in Korea and Japan where it was export driven (Alizadeh, 2000, p. 18).

³ The Shah was restored to power in 1953 through a CIA-engineered coup that overthrew Iran's democratically-elected Prime Minister following his nationalization of the oil industry (see Kinzer, 2003, as a recent, authoritative, resource on this otherwise well-documented external interference in Iran's affairs).

⁴ Accordingly, 'as wealth poured into some urban sectors, ... its transparent lack in others ... visibly heightened growing social contrasts and a deepening image of social stratification.' (Hakimian, 1988, p. 29)

In this context, the role of the mosques as the only organization with nation-wide grassroots activity became crucial. It enabled the Shiite clergy to forge a broad, cross-class coalition, which embraced the bazaar, the modern middle classes, the intelligentsia, the industrial workforce, the urban poor and other groups and social strata. The broad base from which this alliance drew from ended the state's relative autonomy from social groups and, as we shall see, has been at the base of the post-revolutionary state's popular constituency with which it has to contend with.

Two further features of the Iranian Revolution have continued to play important roles in shaping the institutional landscape in this period: the twin promises of bringing about 'social justice' and achieving 'economic independence'. Both were strong ideals of the Revolution, and have made an imprint on the vision and practice of economic policy, in particular, in the years to come.

The strong anti-imperialist, anti-western stance and rhetoric of the Revolution reflected a rejection of the *ancien* regime's dependency on external powers in general and the USA, in particular. A strong desire to turn Iran into an 'independent' economy, indeed, has been behind Iran's pursuit of a generally seclusionist development path since 1979, shunting the globalization trends that have swept the developing countries in recent decades.

Moreover, despite the religious form and leadership of the Revolution, which has overshadowed somewhat its democratic and anti-dictatorial aspirations, the populist element in this process has been strong and lasting – particularly in the economic domain (Abrahamian, 1993; Behdad, 1996).⁵

As with Latin American populism, the Iranian Revolution too was built around a broad coalition of the middle classes led by a strong and charismatic leadership (see Dornbusch and Edwards, 1991, on populism in Latin America). It had popular and egalitarian aspirations based on promises of fraternity, equality and social justice – in direct contrast to the previous era's focus on growth and development. While respecting private property, it had strong connotations of class conflict between the *mostazafin* (downtrodden) and the *mostakberin* (oppressors) and promised to emancipate the former from all injustices of the monarchist era. This, involved, pledges to build a society 'free from want and hunger, slums, drugs and inequality, and nepotism and corruption' (Abrahamian, 1993: p. 32).

As Acemoglu and Robinson (2006) have demonstrated, the transition from dictatorship to democracy is not necessarily a linear process with an assured outcome. In the Iranian example, too, after nearly three decades, this contradictory process seems to have resulted in a *hybrid* political form, which combines aspects of both democracy and non-democracy.

On one hand, Iran is unique in offering universal suffrage which starts at an unusually early age of 15.⁶ Moreover, participation rates in most elections tend to be high especially by the standards of established democracies.⁷ Yet, these 'popular' elections operate on the basis of highly limited franchise and are subject to vigorous, and controversial, vetting of the candidates by non-elected bodies such as the Guardian Council.⁸ This system thus combines elements of 'democracy' on the demand side (offering opportunities for expressions of 'popular' choice) with 'non-democracy' entailing restrictions on the supply side (which limits the pool of candidates and political parties). Given the contradictory nature of the system, which, for lack of a better term, we may describe as a '*participatory non-democracy*', it is not surprising that it often confounds both critics and supporters alike.

⁵ External characterization of the Islamic regime as 'fanatical' and 'fundamentalist' too have contributed to this obfuscation of its populist characteristic (Abrahamian, 1993).

⁶ In Cuba, Nicaragua and Brazil the minimum voting age is 16. Elsewhere, it is nearly universally 18.

⁷ The turnout in Iran's presidential election in 2005 was 60% (second round) and 63% (first round). In the 1997 and 2001 elections, these were 80% and 66%, respectively.

⁸ The Iranian constitution permits the establishment of political parties and professional syndicates as long as they conform to the Islamic basis of the Republic. In the 2005 presidential elections, about one thousand candidates were disqualified, only eight were approved of whom seven ran. Similarly, of the 814 candidates who declared their intention to run in the 2001 presidential election, only ten were approved.

At an abstract level, Iran's quest for democracy, and the upheavals leading to the Revolution in 1979, too, may be viewed as strategic behavior involving 'conflictual social choices' between two broad opponent groups (Acemoglu and Robinson, 2006): citizens (a broad coalition of different classes and social groups) and elite (the Shah and the royal court backed by higher echelons of the military, and external powers). Yet in the Iranian case, both the process and outcome of this confrontation have been distinct in a number of ways.

First, rational choice and optimal behavior would imply knowledge and information that was clearly absent in this context. There were no known blueprints for the promised type of (Islamic) Republic and much of what was on offer in the new social and economic order had to hinge on broad perceptions, if not promises and hopes. For this reason, an element of ambiguity has permeated developments in Iran in the post-revolutionary period with far-reaching consequences particularly in the economic policy area.

Second, Iran's quest for democratizations did not arise in the classic conditions of economic and political crises.⁹ On the contrary, it followed the prosperity associated with the oil-boom period of the 1970s, implying that growing inequality and perceptions of relative poverty in these years may have had more to do with the desire for revolutionary change than impoverishment and hunger *per se*.

As we shall see oil revenues have continued to exert an undue influence over Iran's growth and economic performance as well as in shaping popular expectations over the distribution of political space and economic resources in the post-1979 period.

In the next section, we examine the growth record of the post-revolutionary period before coming back to examine the economic policies and challenges in the following three decades or so.

3. An Overview of Growth

Overall, Iran's economy recorded an annual average real growth rate of 4.6% over the four and a half decades between 1960 and 2005. While this aggregate long-term growth rate is marginally above the comparable rate for the MENA region (with an average growth rate of 3.8% per annum), it is below the rate for the wider group of Lower-Middle Income economies of which Iran is part of (estimated at 5.3% per annum).¹⁰

This record should, however, be qualified in at least three important ways. First, it masks gross discrepancies over time (especially after the late 1970s, as we shall see). Second, it needs to be studied in a comparative context to shed light on Iran's relative performance vis-à-vis her peers. And last, but not least, allowing for population growth (especially after the 1980s), would offer a different picture.

In general, evidence suggests that Iran's growth performance deteriorated after the late 1970s. This is true both in a comparative light as well as compared to the period over time (see Hakimian and Karshenas, 2000, and Karshenas and Hakimian, 2005).

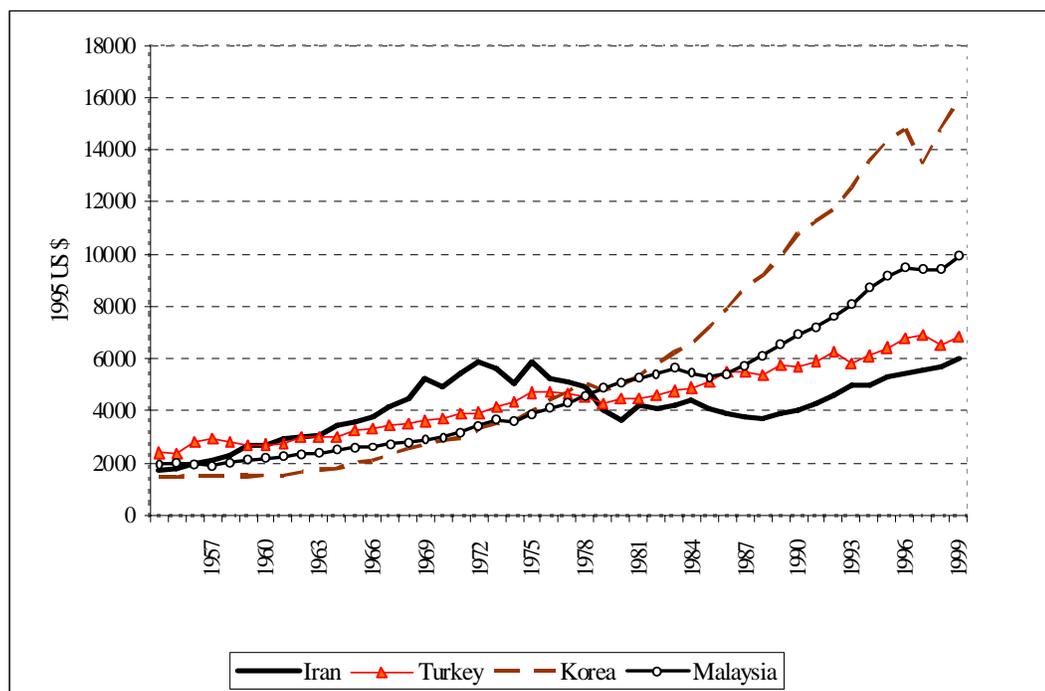
Below, we offer an analysis of Iran's performance against three different comparator groups over different time periods: a select number of high performance developing countries (LDCs); Lower-Middle Income economies (LMCs) and the oil economies.

⁹ Acemoglu and Robinson predict that democratizations are more likely to arise in a situation of economic and political crisis. Relevant examples are: harvest failure, economic depressions, international financial or debt crises, and even wars (2006, pp. 30-31 and p. 65).

¹⁰ World Bank Development Indicators data. The latter figure (5.3%) for the LMCs should, however, be treated with caution as: (a) it refers to an ex-post country classification as of July 2006 (consisting of 58 countries deemed to fall in this category); and (b) the heterogeneous nature of the countries included (for the former Soviet Republics, for instance, data stretches back to early 1990s only).

Comparison with high performers such as Korea, Malaysia and Turkey highlights the sharp trend reversal in Iran's growth performance in the last decades of the twentieth century (Figure 1). For instance, in the period between 1955 and 1975, Iran's per capita income grew faster than these three peers. Since the mid-1970s, however, Iran's growth rate has faltered with a widening gap emerging especially with South Korea and Malaysia, both of which have increased their per capita GDP consistently (exceeding double their levels in the late 1970s). The fact that another oil economy such as Malaysia has outperformed Iran's growth in this period suggests that being an oil economy need not be the root cause of sluggish economic performance.

Figure 1: Per Capita GDP Trends in Iran, Malaysia, Korea and Turkey, 1955-2000



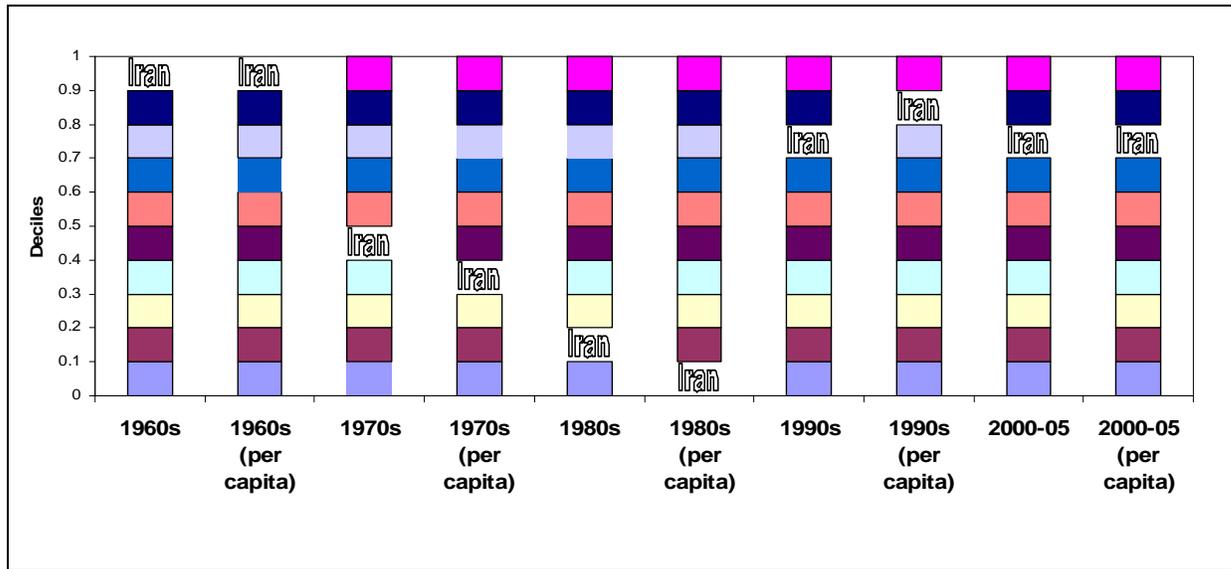
Note: Figures refer to real GDP per capita in constant dollars expressed in international prices (base 1995).

Source: Karshenas and Hakimian (2005), based on Heston A., R. Summers and B. Aten, Penn World Table Version 6.1.

Comparisons with Turkey are no less instructive. Starting from similar per capita income levels in the early 1960s, Turkey has followed a more steady growth path, and after the collapse of growth in Iran in the 1980s, has overtaken Iran. It is true that much of the catching up by Turkey took place during Iran's war with Iraq in the 1980s (from which Turkey and other neighboring countries benefited economically). However, sustained economic growth would not have been possible without far-reaching economic reforms introduced after the early 1980s resulting in a higher efficiency of investment and greater economic diversification, especially rising manufacturing exports (Karshenas and Hakimian, 2005: 71).

Compared with other Lower-Middle Income economies as well as with other oil economies, Iran's story is no less interesting. Figures 2 and 3 show a 'league table' style record of comparative growth performance for the group of LMCs and oil economies, respectively. Figure 2 shows that Iran was a top performer in the 1960s – judged by annual real growth rates, and then sank somewhat to below the median position in the 1970s, before plunging to the bottom of the table in the harsh 1980s' decade. After that Iran has improved its relative performance again both in GDP and GDP per capita bases, moving to the top three deciles in the 1990s and after 2000.

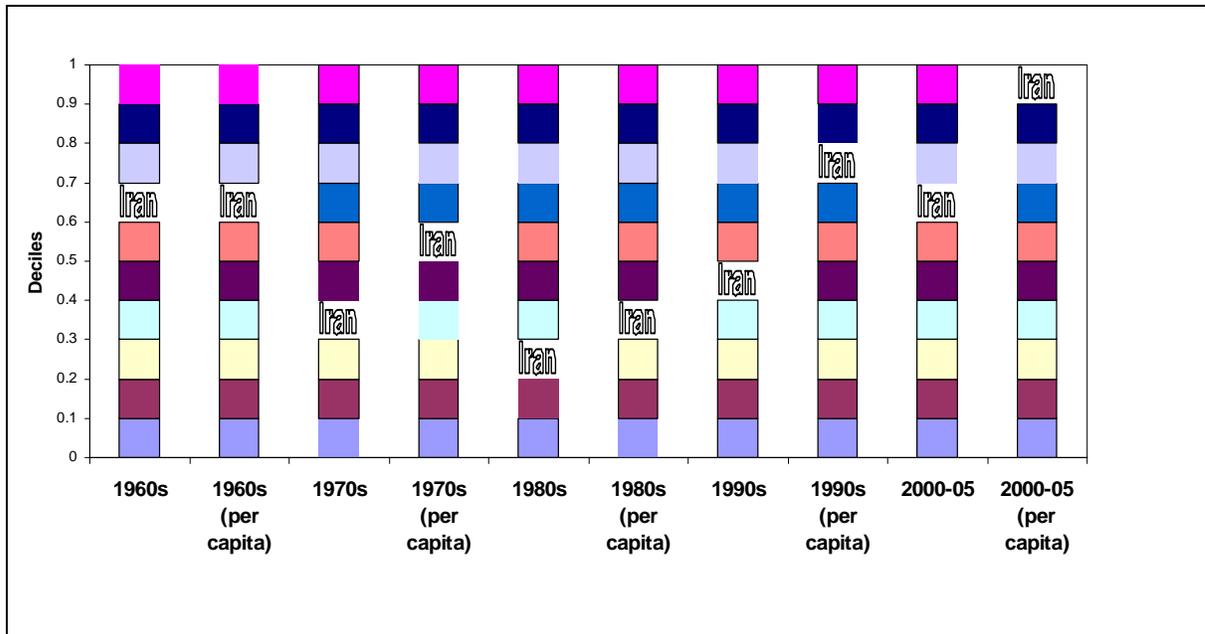
Figure 2: Iran's GDP and GDP per capita Growth Ranking among LMCs, 1960-2005



Note: World Bank classification as of July 2006. Lower Middle Income Countries (LMCs) comprise 58 countries including eastern block countries and former Soviet republics for which data refer to period after the early 1990s. The number of countries embraced by the classification is therefore variable between different decades and should hence be treated with caution.

Source: Calculated from World Bank, Development Indicators (2006).

Figure 3: Iran's GDP and GDP per capita Growth Ranking among Oil Economies, 1960-2005



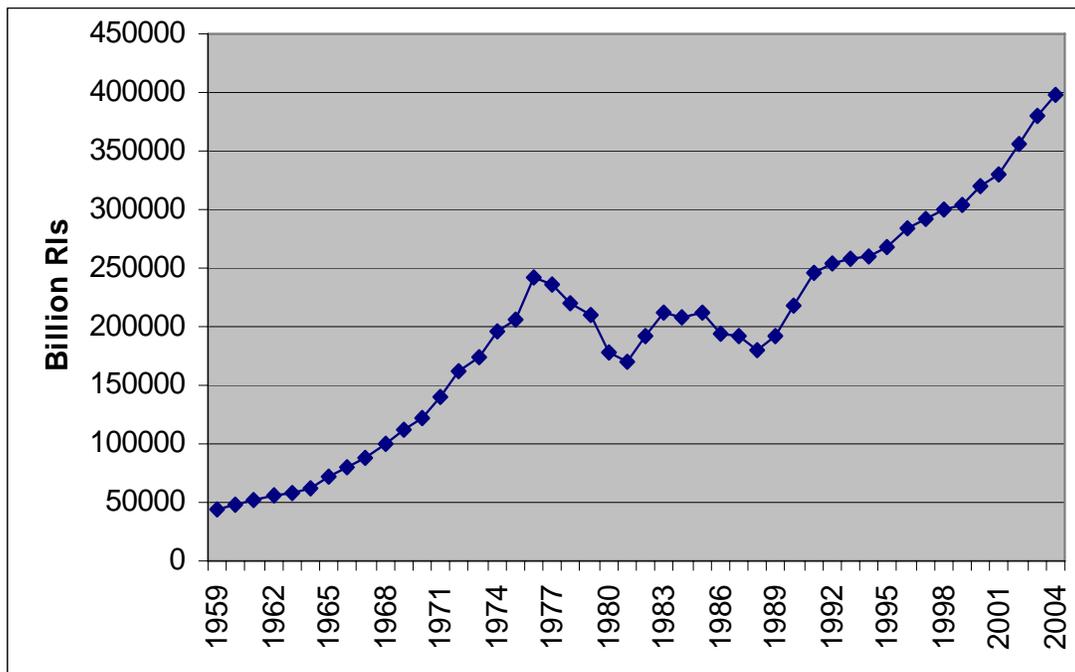
Note: Oil economies included are: Algeria, Bahrain, Indonesia, Iran, Kuwait, Libya, Nigeria, Oman, Saudi Arabia, UAE, Venezuela and Yemen. Qatar is excluded due to data limitations. The number of countries embraced by the classification here is variable between different decades reflecting data limitations, and should hence be treated with caution.

Source: Calculated from World Bank, Development Indicators (2006).

Figure 3 offers a useful comparison against the oil economies. It can be seen that here, too, was a similar 'U-shaped' trajectory whereby Iran's relative performance sank in the 1980s before recovering later, but with a less severe 'trough' indicating that the 1980s' oil markets turbulences was not confined to Iran alone and affected other oil exporters, too. What is further interesting is that against the oil economies, Iran did relatively better on a *per capita* basis than its general GDP growth rankings. This happened despite sharp sways in Iran's demographic behavior after the 1970s (Hakimian, 2006). That is to say that Iran's population growth has outperformed other oil producing nations including perhaps somewhat surprisingly during the 1980s, when she experienced a notable fertility surge resulting in one of the fastest growing population rates in the world (reaching almost 4 percent in the 1980s; see further Section 4.1 below).¹¹

Figure 4 depicts Iran's GDP in real terms since 1959 (in constant 1997/98 prices). Three general phases are readily evident from this long-term trajectory of Iran's real income and how it has evolved over time. The rapid rise in two decades prior to the Revolution (1960s and the first half of the 1970s); the collapse and contraction period of the 1980s; and the resumption of growth after the early 1990s. This rather clear-cut and well-differentiated pattern of two GDP growth phases punctuated by one (albeit long) collapse period may lead one to conclude that – bar an exceptional period of stagnation and decline itself occasioned by revolutionary upheaval and war with Iraq in the 1980s – Iran has been a high performer during most of the last four and a half decades and is now back on its 'sustainable growth track'. A more detailed examination of Iran's *growth* performance especially when disaggregated into the relevant sub-periods, however, suggests otherwise.

Figure 4: Iran Real GDP: 1959-2004
(constant 1997/98 prices)

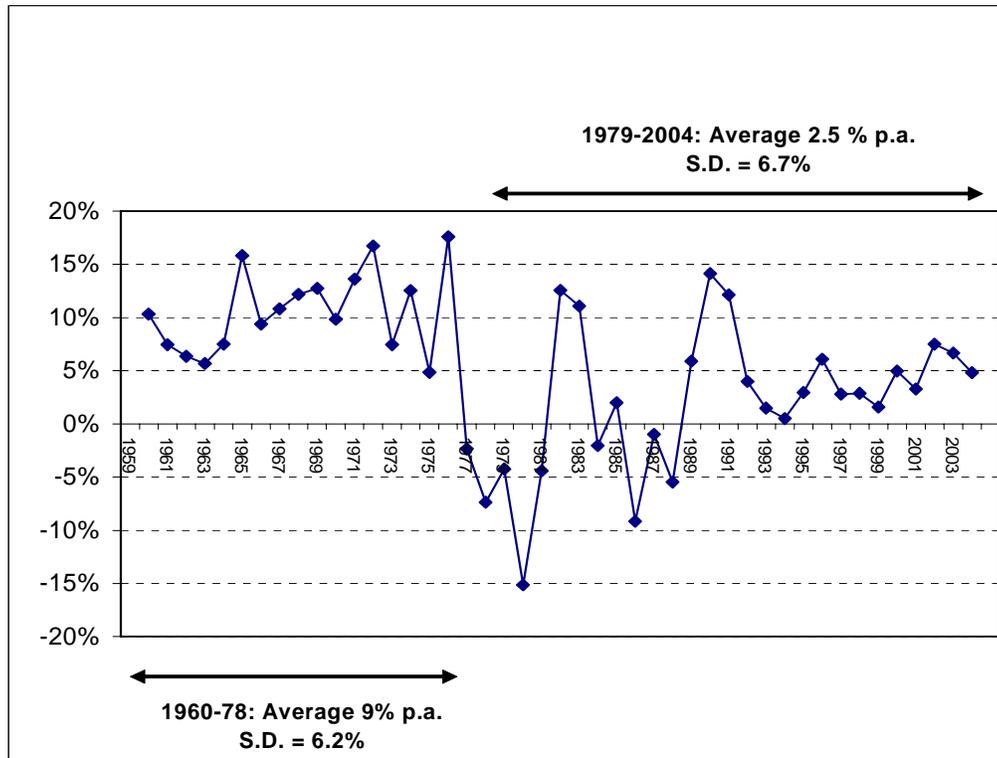


Source: Central Bank of Iran.

¹¹ For a discussion and overview of the phenomenon commonly referred to as the Middle Eastern 'demographic puzzle', see Omran and Roudi (1993).

Figure 5 depicts the GDP growth performance in Iran since 1960 and Table 1 provides more detailed information on various sub-periods since then. It can be seen that growth has specially suffered setbacks and endured heightened volatility for much of the period since the late 1970s. While real GDP growth has averaged 5.3% per annum for the four and a half decades since 1960, there has been a gross discrepancy between the growth performances before and after the Revolution. Prior to 1979, Iran's economy grew 9% per annum in real terms or more than three and a half times faster on average than after 1979 (real GDP growth averaged 2.5% per annum during 1979-2004; Table 1). While growth averaged 10.6% per annum in the period 1960-72, the fastest growth rates ever attained were during the heyday of the oil boom in the 1970s, with growth hitting an all time high of about 17% in 1972 and 1976.

Figure 5: Iran's Growth Rate (1960-2004)



Source: Central Bank of Iran.

As stated above, inevitably, the Iranian economy suffered the most in the 1980s following the revolutionary upheavals of the late 1970s and a long and destructive war with Iraq: the economy contracted by 1.3% per annum in real terms during this period covering most of the 1980s. Even excluding this difficult phase from the growth picture, it is clear that Iran's growth has under-performed compared to the period before the Revolution: the growth rate for the post-war period (1989-2004) has been 5.1 % or just over half the rate for the Shah's years.

The most significant episode of growth in recent years came in the early 1990s, during a brief period of post-war reconstruction and economic reform when growth rates came close to matching the pre-revolutionary period (averaging 7.5% per annum during 1989-93 compared to 8%-9% per annum in the 1960s and 1970s). This period, however, abruptly ended amidst the debt crisis of the mid-1990s (see

below). More recently, growth rose again during the Third Plan years (2000-2004), helped – as we shall see – by another period of buoyancy in international oil prices.

Table 1: Overview of Iran’s Growth (1960-2004) by Sub-Periods

Average Annual Real GDP Growth Rate (%) ^(a)			
	Mean	STD	
Before the Revolution			
1960-72	10.6	3.5	Before the oil-boom years
1973-77	8.0	7.6	The 1970s’ oil-boom years
1960-78	9.0	6.2	The Shah’s years
After the Revolution			
1980-88	-1.3	8.9	War years
1989-93	7.5	5.4	First Plan
1994-99	2.8	1.9	Second Plan
2000-2004	5.4	1.7	Third Plan
1989-2004	5.1	3.7	Post-war years
1979-2004	2.5	6.7	All Islamic Republic Years
1960-2004	5.3	5.3	Entire period

^(a) At constant 1997/98 prices.

Source: Central Bank of Iran.

As Table 1 shows, Iran’s post-revolutionary economic growth can be more specifically studied in three sub-periods:

1. **The 1979-88 period:** this period covered the early years of Revolution, a long war (with Iraq) and a general trend of economic populism in Iran. We may think of these years as the ‘ideological’ period during which the new regime was consolidating its control over the economy.
2. **The 1989-93 period:** these years saw a major drive at economic reconstruction and economic reform under the auspices of the First Five-Year Development Plan that followed the end of war with Iraq. This period signified the onset of a new, ‘pragmatist’, phase in the Islamic Republic.
3. **The 1994-2004 decade:** this period faced initially the twin challenges of managing an external debt crisis at the beginning of the Second Development Plan (1994-99) and restoring equilibrium in Iran’s external accounts. Having emerged through this crisis, the task was then to resume macroeconomic reforms and achieve greater macro stability during the Third Plan (2000-04). The road from crisis to reform in this long decade was paved with much uncertainty over the direction of economic policy, in general, and one in which Iran’s political economy scene was rocked by intense political strife and factional politics.

We now offer a broad discussion of the nature of challenges and policy responses in each of these sub-periods before coming back to examine the structural features of and institutional impediments to growth in Iran in the following section.

4. Policy Challenges and Responses

4.1 Populism and War (1979-88)

This period was characterized by the ideological fervor of the early revolutionary period and the destructive effects of war with Iraq (1980-88). The most prominent populist themes throughout the 1980s embraced such issues as the Islamization of the economy, emphasis on social redistribution, and attaining economic independence and self-sufficiency (Behdad, 1996, Mazarei, 1996). However, there was a tension between the new administrations' religious idealism and the requisite economic management by government, which lacked coherence and clarity. The result was intense debates and political scrutiny by different forces and factions in the society and within the government. While war provided a pretext for tactical patching up of some of these differences, as we shall see, many ambiguities persisted and have continued to mar policy making and reforms in the coming years (for instance, the role of interest in banking, attitudes to foreign direct investment, and more generally the boundaries between state and the private sector).

In the immediate aftermath of the Revolution a considerable portion of the large-scale modern industry as well as the entire banking and insurance system was nationalized. These nationalizations were to some extent forced on the government as in many cases the owners and managers of factories had left the country and some enterprises were on the verge of collapse.

With the advent of war in 1980, the debates about the role of the private sector and markets took a new turn as the government introduced an intricate system of rationing and direct subsidies for a large number of commodities. Government controls in other economic spheres also increased significantly. Foreign exchange shortages, which became particularly acute from the mid-1980s, led to a policy of import compression and strict foreign exchange controls and rationing.¹² The shortfall in oil revenues precipitated by the collapse of the international oil prices in the mid-1980s coincided with increasing demand on government resources leading to substantial budget deficits and heightening inflationary pressures in these years.

The government role in the post-revolutionary period thus expanded substantially, going well beyond a shift of balance from private to public ownership. Increasingly, it was manifested in direct interventions in the operation of markets. For instance, intervention embraced foreign exchange controls, maintenance of a system of multiple exchange rates, control on interest rates and bank credits as well as direct price controls in a large number of markets. By the end of the war, indeed, there had appeared an extensive network of controls embracing some 300 products that were subject to official price controls (Hakimian and Karshenas, 2000).

Despite the government's efforts to keep the economy afloat and to avert the worst consequences for the populace, the Iranian economy suffered major setbacks in this period. The resource base continued to shrink as there was a massive diversion of resources for military purposes and to sustain the ongoing war effort; the country suffered a significant international brain drain; and physical and human destruction went on a massive scale.

Particularly severe was the contraction of the oil sector, which had taken the brunt of the war with Iraq. The destruction of oil production facilities and lack of investment had severely affected Iran's oil production, which collapsed from 5.8 million barrels a day in the 1970s to about 1.4 million early on in the war (1981). The oil sector's share of GDP too had plummeted from a peak of about 25 percent in the mid-1970s to merely 5 percent in 1981 (World Bank, 2003: Chapter 1, p. 3).

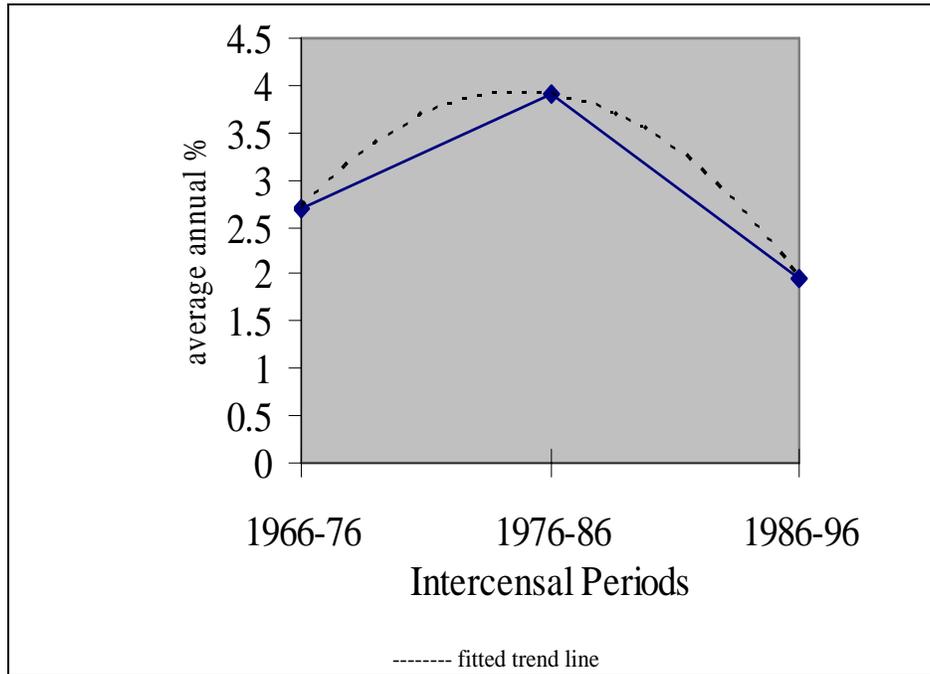
Another development of lasting significance in the first decade after the Revolution was a major surge in Iran's population growth. Reaching an average annual growth rate of almost 4 percent in the mid-1980s, Iran's population was by now one of the fastest growing in the world (see Figure 6).¹³ In the intercensal period 1976-86, Iran's population thus expanded by nearly 50 percent to embrace just under 50

¹² See Lautenschlager (1986); Behdad (1988); Pesaran (1992); and Karshenas and Pesaran (1995) for a discussion of the foreign exchange regime in Iran in these years.

¹³ For a more in-depth discussion of Iran's population issues after the revolution, see Aghajanian (1991) and Hakimian (2000 and 2006).

million people. This implied a (net) total addition of about 16 million on a population base of just below 34 million in 1976 (three years before the Revolution). Measured by child–woman ratio (CWR), fertility rose 17 percent during this period (reaching almost 860 children per thousand women of reproductive age – up from 732 a decade earlier; Hakimian, 2006).

Figure 6: Iran - Population Growth Rate (1966-96)



Source: Based on census data by the Statistical Centre of Iran.

Underpinning what was arguably a ‘reversal’ of Iran’s earlier demographic transition was the adoption by the government of strong pronatalist policies from early on after the Revolution. These included shutting down family planning clinics, promoting early marriage, lowering the legal age of marriage (to nine for girls and fourteen for men), and discouraging birth control. These measures were reinforced by strong undercurrents of ‘Islamization’ which shaped and defined the new regulatory and socio-economic environments in which women found themselves under the new regime. In general, these aimed to redefine their role in the economy and to encourage their retreat into the family and domestic arenas. In this context, the resulting baby boom of the 1980s was initially hailed officially as an important indicator of ‘success’ for the government. However, as we shall see below, by the late 1980s concerns with rapid population growth, and its growing burdens on the economy, led to one of the most notable population policy (and in due course demographic trends) reversals of modern times (Hakimian, 2006).

A dramatic collapse in international oil prices in 1986 compounded these pressures, which were proving to be unsustainable by the latter part of the 1980s. Indicating the severity of the crisis, the economy shrank by over 5% in real terms in the three-year period 1986-88 and the government budget was approximately 50% in deficit by the last year of war (1988). By 1988, indeed, Iran’s real per capita GDP had shrunk to the levels seen in the mid-1960s (Figure 1).

It was against this austere and harsh economic background that the eight-year war with Iraq came to an end.

4.2 The Pragmatic Years (1989-93)

The end of the war with Iraq in the late 1980s opened up a new window of opportunity for economic reform and restructuring in Iran. The impetus for this new drive came partly from the long process of economic exhaustion Iran had suffered during the harsh decade of the 1980s, and partly by the accumulation of long and deep-rooted economic problems since the early days of the Revolution. It was against a background of mounting economic difficulties, shrinking living standards and a contracting public sector resource base that the government embarked on an ambitious reconstruction and economic reform program within the framework of its First Five-Year Development Plan covering the period 1989-93 (Hakimian and Karshenas, 2000; Nili, 1997).

The Plan aimed at market liberalization by dismantling the intricate network of price and quantity controls that had evolved over the war years, a gradual liberalization of foreign trade including the removal of quantitative restrictions on imports and exports, and the unification of the exchange rate system.

This was the first significant step, in principle at least, towards promoting the private sector and a general reduction in the state's hitherto dominant position in the economy. In practice, however, the implementation of the Plan ran into problems as reforms were accompanied by an overly ambitious fiscal and monetary expansion leading to serious macroeconomic imbalances. Despite much emphasis on the private sector and the need to reduce the extent and scope of state intervention in the economy, government policy in these years in fact showed little sign of receding. In the end, the implementation and commitment to reforms were scaled back and modified to make space for the public sector-led reconstruction efforts. The outcome of the First Plan reflected some of these tensions.

There was some early success, no doubt. For instance, GDP growth rate shot up to 12%-14% per annum in 1990 and 1991, which was particularly impressive coming after the contraction and decline of the war years (Figure 5 above). However, success was short-lived and could not be sustained at this rate. Economic activity slowed down noticeably in the last two years of the Plan when GDP growth dropped back to single figures (4% in 1992 and a mere 1.5% in 1993). The slow-down in growth was also accompanied by inflationary build-up with the consumer price index jumping by about 23% in 1993 and liquidity expansion (growth of M2) exceeding 34% in the same year.

The Plan's implementation, was however, ultimately marred by an external debt crisis, which broke out in the latter part of the period and led to severe imbalances in Iran's external accounts. Austerity measures adopted in 1994 to deal with the crisis signaled the end of the rapid growth phase. By 1994, the economy was virtually at a standstill and the reforms were gradually scaled back and reversed. Thus was the case of the newly unified exchange rate system which was thwarted in late 1993 less than a year it had been introduced (Farzin, 1995). Matters were further complicated in these years by declining oil revenues after 1992 stagnating at about \$14 billion in 1993 and 1994 (down from \$18 billion in 1990).

Despite the First Plan's mixed fortunes and the government's subsequent wavering commitment to reforms, the Plan was a watershed in the development of Iran's post-war economy. First, it played a major part in dismantling the country's centrally-administered economy in the late 1980s. Second, it initiated – albeit slowly – the beginnings of the economic adjustment and reform agenda with its ramifications continuing to the present.

The First Plan's successes emanated partially from the energizing effect of the reform measures themselves, which proved to be particularly important after years of central control and state administration of the economy. Although few far-reaching measures were adopted to address the problem of weak productive efficiency in the economy (such as in the ailing industrial sector), the reforms did, by virtue of their focus on allocative efficiency, take important, if somewhat modest, steps to address some of the gross distortions that had crept into the Iranian economy during the earlier populist years.

Another impetus came from the '*peace dividend*' itself. For the first time after about a decade, resources did not have to be diverted to maintain an expensive war effort and could be used to foster construction.

Economic boom was also fuelled, at least partially, by increases in oil revenues in these years. This was true of the early years of the Plan, in particular, when government spending was boosted by a doubling of oil revenues. For instance, foreign exchange revenues from oil sales almost doubled between 1988 and 1991: rising from \$9.7 billion to about \$18 billion, when it accounted for some 60% of all government

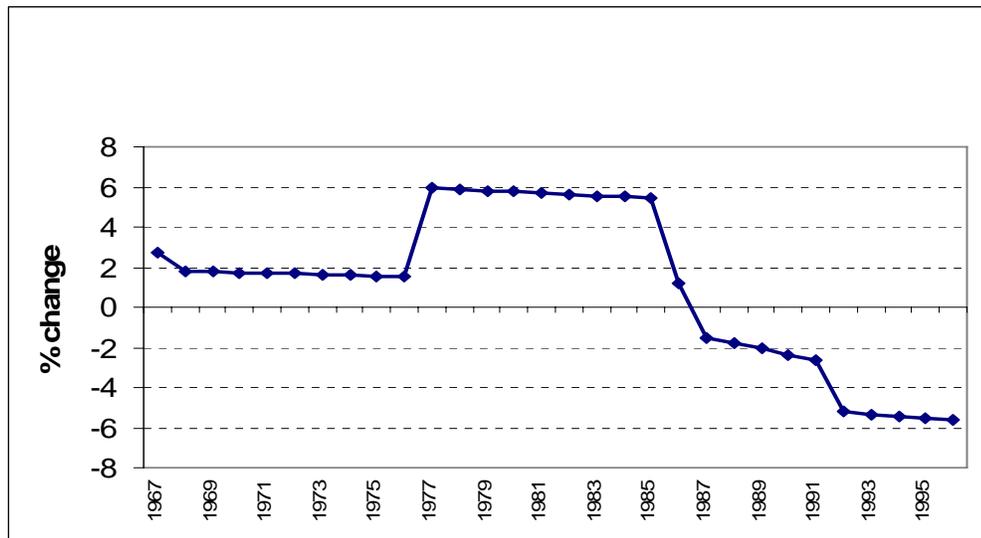
revenues (up from 39% in 1988).¹⁴ Oil export revenues averaged about \$14.5 billion for the entire Plan period of 1989-93 (Table 2 below). There were other contributory factors too.

First, the baby boom of the early 1980s had moderated substantially by now, although the lasting effects of the population momentum from the earlier period continued to be a burden on the economy. Reflecting mounting concerns over population growth, the earlier pronatalist policies were swiftly and decisively reversed by the late 1980s. A hallmark of this period was the introduction of an active population control program, which marked a significant U-turn in official thinking and policy after 1988. At the heart of this policy was a supply-side approach in which the Ministry of Health and Medical Education (MOHME) set up an extensive Primary Health Network (PHC) made up of the so-called Health Houses in rural areas to distribute and promote contraceptives. Later on, demand side factors too were introduced which offered incentives to limit family size. For instance, starting in the early 1990s, official child benefits were limited to three children per household only.

Such was the extent of the population policy reversal – and arguably its success – that by the early 1990s, Iran had succeeded in resuming its stalled demographic transition with a vengeance and was now established at the forefront of demographic transition in the MENA region (Hakimian, 2006).

Figure 6 above shows that in the last three decades, the population growth rate first rose sharply and then fell back (suggesting a 'hump' shape). As mentioned before, average annual population growth rate climbed to nearly 4 percent in the intercensal period 1976–86, followed by a steep fall in the 1990s. The fall was especially pronounced in the second half of the 1986–96 period, with annualized growth rate dropping to just 1.47 percent in the five-year period 1991–96.

Figure 7: Annual % Change in Iran's Population of Children Aged 0-4 (1967-96)



Source: Hakimian (2006) based on census data by the Statistical Centre of Iran.

Figure 7 sheds more light on Iran's experience of 'fertility boom and bust' in the span of the three decades between the mid-1960s and mid-1990s. It shows annual percentage changes in Iranian children aged 0–4 between 1967 and 1996. This too confirms a contrasting pattern of a rapid surge in fertility in the

¹⁴ The rise in oil revenues was partly due to price increases in the wake of Iraq's invasion of Kuwait and partly due to the expansion of output. Crude oil exports increased by 43 % between 1988 and 1990, and by another 28 % between 1990 and 1993, as production and export facilities damaged during the war were gradually restored.

1980s followed by a steep decline in the 1990s. It can be seen that a moderately declining trend of the early 1970s was suddenly reversed in 1978, when the annual growth rate of the number of young Iranians jumped to 6 percent (it had been under 2 percent in much of the previous decade before the Revolution). Thereafter, the population growth tempo stayed high until 1986 when a sudden and sharp fall put an end to the booming number of the young. Evidence of baby bust is particularly manifest in the sharp falls in the growth rates recorded in 1986 and 1987 but also sustained thereafter. As we have seen, dramatically reversing the baby boom of less than a decade earlier, the growth rate of this cohort of population has continued to fall sharply, edging close to –6 percent per annum since 1992.

Another important factor in these years Iran's changing interaction with the rest of the world. It was in the third Plan years that after years of pursuing seclusionist policies and relative insulation from the international economy, external savings began to supplement domestic resources. Foreign capital (mostly bank loans) began to flow into Iran soon after the reconstruction program got under way. While foreign competition to lend to Iran was keen, Iranian appetite for foreign loans to finance its post-war reconstruction drive was also significant. By 1992, however, it was already clear that short-term (mostly trade-related) debt had been accumulated in an unsustainable manner and the country was in the throes of a big debt crisis. Although neither the volume (\$23 billion in 1993) nor the relative size of external debt (one-third of GDP) should have been of direct concern, its composition was and led to an external imbalance (It was made up of principally short-term trade finance (debts of less than one-year maturity averaged 80% of the total during the entire First Plan period). Most importantly, the onset of the debt crisis revealed serious gaps in Iran's macroeconomic policy management and exposed lack of cohesion, communication, monitoring and coordination of policy making during this period of increasing exposure to the international economy (Frazin, 1995, Hakimian and Karshenas, 2000: 51-7).

Above all, perhaps, the debt crisis also exposed the high economic cost of Iran's isolationist stance. The inability of the country to raise long-term credit in international markets meant that much of the debt consisted of suppliers' credit, suggesting that short-term finance had been used on a large scale for medium and long-term investment projects with longer gestation periods.

The government's abortive attempt at the unification of the exchange rate system in March 1993 too was another example of failing reforms in these years. The timing and the manner of the unification attempt was also indicative of implementation weaknesses rooted in administrative inconsistency and lack of cohesion and coordination that ultimately marred the results of the reforms.

4.3 From Crisis to Reform (1994-2004)

The decade after the mid-1990s was characterized by a gradual – and non-linear – move towards restoring macroeconomic stability and introduction of limited reforms. First and during the implementation of the Second Five-Year Plan (1994-99), the economy contracted sharply. In this phase, as mentioned above, much of the First Plan reforms were either aborted or reversed in response to the international debt crisis of 1993/94. Second, and after the introduction of the Third Plan (2000-2004), Iran's economy witnessed the return of relative stability and the resumption of gradual reforms. These two phases were separated by a period of policy ambiguity and wavering, punctuated by the international oil price collapse of the late 1990s.

The austerity measures introduced in 1994 to deal with the debt and balance of payments crises were swift, decisive and ultimately highly successful in restoring external equilibrium.¹⁵ However, their impact on the economy retarded growth and its short-term costs proved particularly harsh.¹⁶ Consequently, real GDP growth plummeted to 0.5% per annum in 1994, which was below the population growth (of 1.5

¹⁵ This was done primarily through a strict import compression regime. Imports were slashed by one-third in 1994 alone, and overall the Second Plan's average imports bill was about a third lower compared to the First Plan (\$13.7 billion against \$19.9 billion; Table 2). Total foreign debt was thus successfully re-negotiated and by the end of 1997 slashed down to about half its peak in 1993.

¹⁶ Import compression, in particular, exacerbated macro inefficiency as it worsened the problem of low capacity utilization in industrial units by restricting their access to imported intermediate products and capital goods, in turn, accentuating the low growth cycle.

percent) for the first time after the end of war. Overall, growth averaged just under 3 percent in the five years to 1999, against the Plan's projected target of 5.1 percent, and less than half that achieved during the First Plan (7.5 percent; see Table 2).

These years also witnessed persistent inflationary pressures signaling the return of stagflation, which had adversely affected Iran for much of the 1980s. Inflation reached a peak of nearly 50 percent in 1995, and its period average was about 30 percent, well above the period average for the First Plan (itself a double digit at about 19 percent; Table 2).

Table 2:
Selective Comparative Economic Indicators – First, Second and Third Plan Years
(Average Annual Figures)

	First Plan (1989-93)	Second Plan (1994-99)	Third Plan (2000-04)
Real GDP growth (%)	7.5	2.8	5.4
- Non-oil GDP (%)	7.2	3.7	5.8
Fixed Investment (% GDP 1997 prices)	29.4	26.7	33.6
Real private consumption (% change)	7.8	2.8	7.3
Inflation (urban CPI)	18.8	27.2	14.1
Liquidity (M2)	25.2	26.3	28.9
Oil Exports Revenues (million US\$)	15,451.0	15,245.0	26,153.4
Non-Oil Export Revenues (million US\$)	2,348.0	3,540.7	5,645.8
Imports (fob, million US\$)	19,905.8	13,703.7	24,290.2
Current Balance (million US\$)	-4,006.2	3,368.0	5,401.8

All figures refer to realized or actual outcomes during the three Plans.

Source: Central Bank of Iran.

The final years of the Second Plan saw renewed hopes for breaking out of the economic doldrums of the 1990 as a new reformist administration (led by Mr Khatami) took office. Despite its strong political mandate, however, two factors militated against the adoption of a decisive approach to economic reforms: the difficult combination of internal and external macroeconomic conditions it faced from the outset, and the high popular expectations that came with the wide electoral support base it enjoyed. The latter, in particular, led to an initial fuzzy period during which strong but vague populist overtures were punctuated by occasional bouts of pragmatist policies and overtones.¹⁷

It was not until the introduction of the Third Plan (2000-04), when the direction of the government policy became somewhat clearer. Although, the Plan recognized the need for certain structural reforms (in areas such as trade, public finances, exchange rate and divestiture of public enterprises), its main focus, was, however, to resume growth and macroeconomic stability. By this time, external conditions had also improved and the Plan's implementation was aided by the recovery of the international oil prices after 1999/2000.

¹⁷ This was, for instance, evident in the period 1997-1999, when ideals of social justice and 'sustainable development' were stressed alongside those of economic and managerial efficiency (see Hakimian, 2006, for details).

Table 2 shows comparative indicators of this Plan against the previous two. It can be seen that a realized annual growth rate of 5.4% was almost double that achieved for the Second Plan (2.8% only). Besides, the Third Plan managed to dent the stagflationary trap of the previous Plan by resuscitating aggregate demand whilst moderating persistent inflationary pressures. Both total investment and private consumption expenditure rose again, and the inflation rate was almost halved (coming down to a period average of 14.1% against 27.2%).

Significantly, however, and after a long decade grappling with austerity and policy ambiguity, the Third Plan saw the early stages of a number of important structural reforms in the Iranian economy. One of the earliest reforms involved the setting up of an Oil Stabilization Fund (OSF), which aimed to cushion the impact of fluctuations in oil prices on government expenditure. This reform had been necessitated by endemic fluctuations in government oil income in the past, and especially the oil price collapse of the late 1990s, which had reinforced the need to reduce the dependency of public finances on oil revenues.

The setting up of OSF was accompanied by further budgetary reforms in 2002 to make transparent the exchange rate subsidies and from 2003 also the energy subsidy which amounted to 10% of GDP. Until 2002, most government subsidies were provided implicitly through the subsidized exchange rate. These covered a wide range of essential household commodities (such as wheat, rice, oil, sugar, milk, and cheese) as well as imports of medical equipment and pharmaceuticals, fertilizers and debt service payments on publicly-guaranteed debt. Although the government had gradually tried to reduce explicit subsidies to food, they still amounted to substantial sums and constituted about 4 percent of GDP in 2003/04.

In March 2002, following far more favorable external circumstance than the last unification in the early 1990s, the exchange rate was unified leading to the elimination of most foreign exchange restrictions for current account purposes. This unification enabled the government to make food and energy subsidies explicit in its budget.

A spate of other reforms too was introduced during these years. Regarding the external accounts, for instance, steps were taken to liberalize trade: the tariff structure was rationalized and Non-Tariff Barriers were replaced with tariffs during 2000-04. Most export restrictions were eliminated too and a new legal framework for the promotion of foreign direct investment (FDI) was approved in 2002 after a long and drawn-out judicial process.

A number of financial reforms were introduced to encourage savings, too. For instance, more flexibility was allowed in setting the rates of return for both deposits and lending and several private banks were licensed to operate. Participation papers were introduced to finance government projects in a non-inflationary way and to mop up excess liquidity from the market. Iran also adopted a number of important fiscal reforms in these years, including the tax reforms of 2002/03, which reduced both personal income tax rates and corporate tax rates (the latter were reduced from a high of 68% to a single rate of 25%).

Although taking a few modest steps in the direction of reform, the Third Plan's main success was in restoring macroeconomic balance and regenerating growth. It was far less successful in achieving its more strategic goals in the areas of reducing unemployment, encouraging foreign investment, achieving large scale privatization, and reducing reliance on oil exports.

Overall, therefore, the success of this Plan came against a background of increased openness to international trade and increased economic reforms but it also benefited from improved oil prices and sustained fiscal stimulus. Despite these, by the end of the Plan in 2004, official unemployment was still as high as 11.2% (against 13.4% at the start); foreign investment was largely absent from the Iranian economy and the reform of ailing State Owned Enterprises had hardly begun.

5. Structural and Institutional Impediments to Growth

The above discussion of policy challenges and responses in Iran since 1979 has highlighted a number of structural and institutional features that have affected the performance of the Iranian economy since the Revolution. First and foremost, although Iran has a longer history of industrial development and capital accumulation compared to most other MENA countries, its economic structure continues to be much dominated by oil. As we shall see below, this feature continues to affect the way economic resources are allocated at a macroeconomic level and has in fact increased in recent years.

The second set of limitations and constraints to effective resource allocation – and hence growth – have to do with the institutional setting in which government policies have been formulated and implemented in these decades. We shall discuss both these sets of issues in turn below.

5.1 Oil Dependency

The importance of oil in Iran's economy is clearly reflected in the dominance of oil exports in both the balance of payments and the government's fiscal revenues. Despite the varied internal and external conditions facing the first three Plans discussed above (1989-2004), the share of oil exports in total exports has been consistently high at about 80-85 percent. Only during oil price crashes (such as in 1998) did the share drop (still no less than about 75 percent). Similarly, oil revenues amount to more than half all government revenues.

Although non-oil exports have risen in recent years (by two and a half-fold between the First and Third Plans), there are as yet few signs of real economic diversification away from the oil sector. This is by sharp contrast with the experience of other countries in the MENA region. For instance, Turkey and Tunisia have managed to raise their share of manufactured exports in total exports to as high as three-quarters. Egypt and Morocco too have a much higher comparable share (over one-third) in contrast to Iran's only nine percent in the late 1990s.

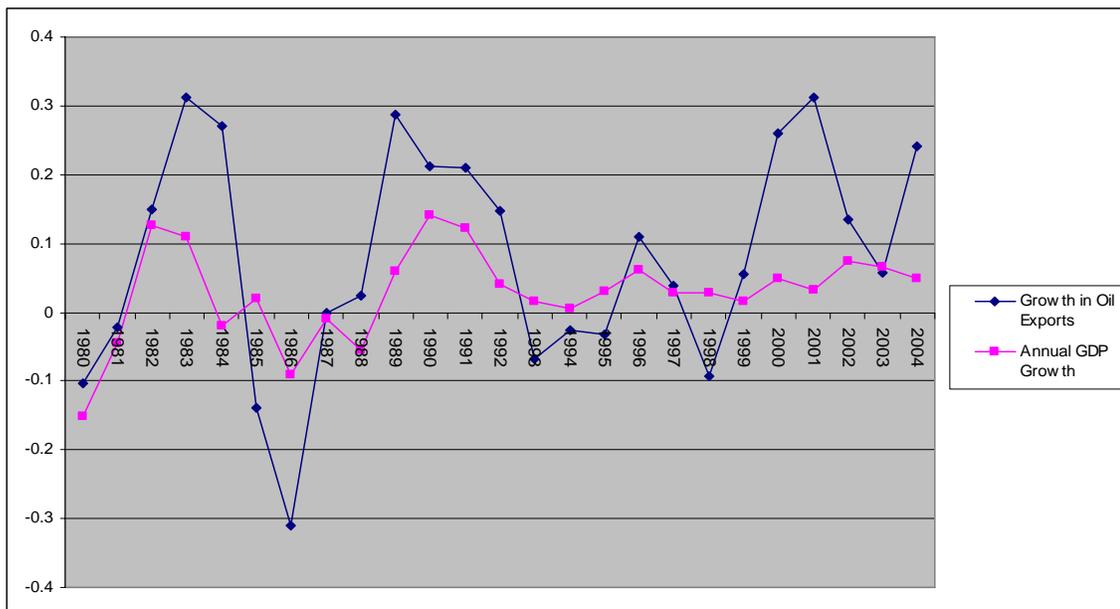
Lack of sufficient diversification and continued high oil dependency are indeed at the heart of Iran's long-term economic problems. Figure 8 underscores the interlinked cycles of oil exports income and real GDP in Iran suggesting a close fit between the two.

This is further supported by a more detailed examination of the nature of economic cycles in Iran and their correlation with the oil boom and bust periods. Table 3 shows a strong relationship between changes in Iran's oil exports earnings and real GDP growth rate during both boom and bust phases since the late 1970s. It can be seen that there is a very strong association between these two variables both on the up and down phases of the growth cycle. For instance, the strongest relative recovery in economic activity after the Revolution (during the two-year period 1982-83) was helped by a strong recovery in oil revenues (exceeding 51% on an average annual basis). Similar growth revivals occurred during 1989-91 (the initial stages of the First Plan), 1996, and more recently in 2000-04 (during the Third plan). In these instances, too, it is clear that buoyant oil revenues have aided recovery.

Strong negative associations too can be observed on the down swing, when drops in economic activity have been accentuated or brought about by a contraction of oil income. Prominent examples of these periods are:

- (a) Early days of the Revolution and breakout of war (1978-81)
- (b) The OPEC crisis of the mid-1980s (1984-86)
- (c) Last year of war with Iraq (1988)
- (d) Austerity package associated with the debt crisis (1994); and finally,
- (e) The oil price slump of 1997/8 and the subsequent recession in 1998.

Figure 8: Cycles of Economic Growth and Oil Exports Income in Iran: 1980-2004



Note: Oil exports are measured in current US\$, three-year moving averages.

Source: Based on data from the Central Bank of Iran.

**Table 3: Boom and Bust Cycles
(% Change in GDP & Oil Revenues)**

	% Change GDP	% Change Non-Oil GDP	% Change Oil Revenues
Boom Phases:			
1982-83	11.8	8.2	51.2
1989-91	10.7	10.2	21.0
1996	6.1	7.1	27.6
2000-04	5.5	5.8	18.8
Bust Phases:			
1978-81	-7.8	-0.9	-9.9
1984-86	-3.1	-1.7	-31.1
1988	-5.5	-7.8	-10.1
1994	0.5	1.8	1.9
1997-98	2.8	3.6	-27.8

Source: Based on data from the Central Bank of Iran.

There is thus little doubt that there has been a strong long-term relationship between oil export revenues and economic growth in both pre- and post-revolutionary periods. However, and perhaps

contrary to most expectations, evidence also suggests that oil dependency has increased during the years of the Islamic Republic. Table 4 puts oil dependency in a broader perspective showing simple and partial correlation coefficients calculated for annual percentage changes in oil exports income and real GDP over sub-periods since the early 1960s. Remarkably, oil dependency appears to have risen during the post-revolutionary periods. In fact the correlation coefficient for the period after 1979 is twice that for the period before (+0.62 against +0.31). Although the peak – meaning the strongest positive correlation – was achieved in the heyday of the 1970s’ oil boom (with a coefficient of +0.77), most sub-periods after 1979 have exhibited a higher coefficient than the long-term trend coefficient of +0.53 for the entire period (1961-2004). The one notable and encouraging exception is the Third Plan period in recent years (2000-04) when, on the contrary and for the first time, we perceive a strong negative correlation (-0.88). As discussed in the last section, this is the period during which an Oil Stabilization Fund was set up to soften the impact of oil price fluctuations on government revenue. Although it is still too early to generalize, it does appear that the setting up of the OSF has in general had the desirable effect of de-linking Iran’s growth and oil exports earnings for the first time.

Table 4: Real Annual GDP and Oil Income Growth Rates: Correlation Coefficients, by Sub-Periods, 1961-2004

	Correlation	
	Coefficient	
Before the Revolution		
1973-77	+0.77	The 1970s’ oil-boom years
1961-78	+0.31	The Shah's years
After the Revolution		
1980-88	+0.64	War years
1989-93	+0.61	First Plan
1994-99	+0.50	Second Plan
2000-2004	-0.88	Third Plan
1979-2004	+0.62	All IR Years
1961-2004	+0.53	Entire period

Note: Oil exports are measured in current US\$, three year moving averages.

Source: Calculated from data from Central Bank of Iran.

It is perhaps ironic that oil dependency has increased overall during the relatively more insular periods after 1979 despite more emphasis being placed on achieving self-sufficiency and economic independence, as discussed in Section 2 above. The root cause of this phenomenon is lack of economic diversification and competitiveness of the non-oil sector in Iran, which cannot be remedied without deep-rooted policy reforms.

5.2 Policy Ambiguity and its Impact on Growth

The foregoing discussion has focused on structural weaknesses in Iran’s economy as manifested in a persistent and increased state of oil dependency. This feature has been exacerbated by inadequate, ambivalent or contradictory policy responses during the different sub-periods after 1979 (examined in

Section 4 above). Despite its renowned mineral riches, therefore, Iran has continues to exhibit deep economic fragility characterized by an uncertain investment climate, fragile public finances and an inward-orientated economy for much of the last two and a half decades.

The root cause of these weaknesses can be traced to two inter-related levels, both of which impinge on the institutional setting in which economic development has taken place in the period under study. These are: the post-revolutionary legal framework and formulation and implementation of policy. These are discussed below.

(a) The Legal Framework

There is little doubt that both public discourse and the conduct of economic policy in Iran have been heavily shaped and constrained by the legal framework that emerged after the Revolution. Iran's constitution is in fact different from Western constitutions for the direct interest it has taken in economic issues, and the attention it has devoted to defining the economic aspects of the post-revolutionary society (Abrahamian, 1993: 33-36).¹⁸ Although respecting private property, the notion of ownership embedded in the constitution has, for instance, set the boundaries between the private and public sectors and has constrained in the main the former's role in the economy.

Article 44 assigned ownership of all large-scale and 'mother industries' to the state sector and consigns, by contrast, the private sector a role that 'supplements' the economic activities of 'the state and cooperative sectors'. This vision was formulated in the 1970s when state ownership of industries was widely acceptable and prevalent. Despite much public debate in 1980s and 1990s, only in 2004 it was revisited to take account of Iran's present fiscal realities as well as the economic performance of loss-making SOEs. Although public debate over forms of ownership was most intense in earlier years (see discussion of the 1980s in Section 4.1 above), this ambivalence has continued to taint recent discussions of reforms in general, and privatization, in particular.

Such ambivalence is also reflected towards foreign ownership and involvement in the Iranian economy. Deep-rooted in economic history and going back to the popular back-lashes against exploitative concessions granted by monarchs in the late nineteenth century,¹⁹ the Iranian legislature has felt obliged to keep a watchful eye on the extent of foreign involvement in Iran. For instance, the constitution goes into some detail to spell out the limits to foreign involvement as several of its provisions, indeed, severely curtail, or directly ban, foreign ownership or interference in any sphere of the economy.

Article 81, prohibits the establishment of foreign companies or organizations in most key sectors of commerce, industry, agriculture, mining and services. Article 82 forbids the employment of 'foreign experts except in cases of necessity' and only then subject to parliamentary approval. Likewise, Article 83 prohibits the transferal of property to foreigners without such approval. And last, but not least, Article 153 prohibits the conclusion of agreements that would result in foreign control of natural resources, economic resources, military affairs, culture, and others.²⁰

Other than complexities rooted in the Constitution, law-making has been complicated in practice, too, by a legislative process, which requires all approved bills to be vetted by another clerical body – The

¹⁸ The constitution, for instance, 'promises to make Iran fully independent, pay off external loans, cancel foreign concessions, nationalize foreign companies... balance the government budget and encourage "home ownership"' (Abrahamian, 1993, 36).

¹⁹ For the so-called Tobacco revolt of 1891-2 and the role of clergy in the boycott initiated against the concession granted to an Englishman called Major Talbot, see Keddie, **.

²⁰ See details of '*Constitution of the Islamic Republic of Iran*, 24 October 1979'; and its amendment on 28 July 1989, http://www.oefre.unibe.ch/law/icl/ir00000_.html

Guardian Council – for their compliance with Islamic principles.²¹ Since this body has the power to reject legislation approved by parliament, yet a third high level body – The Expediency Council – was created to adjudicate between them. The result, as we shall see below (in the context of legislation for the protection and promotion of foreign investment), is a complex labyrinth of decision making amenable to intense internal strife and factional politics.

(b) Policy formulation and implementation

As we have seen, official policy in Iran has evolved in an ambiguous and contradictory manner within alternate cycles of populism and reform. For most of the time after 1979, Iran has been ideologically set on an isolationist path which stresses self-sufficiency and shuns foreign investment. Partial attempts under the First Plan to encourage greater international integration ran into deep structural problems: the unification of the foreign exchange in 1993 failed due to bad timing, poor design and weak implementation. Moreover, the international debt crisis, unleashed by the imports spree after the war, led to greater austerity for much of the 1990s. Both these events helped set the clock back in terms of redefining Iran's role and place in the international economy. Following several years of hesitancy and wavering, the Third Plan finally seemed to begin to address some pressing reforms. By 2000, some attention was given to, albeit in a modest manner, to increasing the role and diversity of the private sector, reducing obstacles to foreign and domestic investment, initiating privatization, supporting export-led growth and developing the non-oil sectors.

The outcome, as we have seen, was encouraging, at least judged by short-term macroeconomic indicators. Realized growth rate was almost double that for the previous Plan period (Table 2). External accounts improved significantly, aided partly by favorable oil prices after 2000. The current account, trade balance and external debt obligations all stabilized and foreign exchange reserves strengthened substantially (IMF, 2003 and 2004). Of more long-term significance, perhaps, non-oil exports, which had dipped after 1997, climbed back to achieve on average 14 percent year-on-year growth in the period 2000-04. Inflation moderated at about 15 percent. However unemployment, proved to be stubbornly high at a double digit figure of over 11 percent.

These short term improvements, should not mask the environment of institutional ambiguity which has continued to affect economic performance, adversely inhibiting Iran from achieving its greater economic potential (see comparative growth data presented in Section 2 above). Indeed, some of the toughest structural changes that could transform the competitiveness of the economy are yet to be tackled both in terms of domestic and external economic policies.

Some observers have characterized Iran's failure to achieve structural transformation since 1980 as a state of 'structural trap'. This is defined as the situation 'in which political and economic obstacles avert the reallocation of capital from low productivity firms and sectors to high productivity ones' (Alizadeh, 2003). Accordingly, Iran's economy remains dominated by inefficient, subsidized and loss-making state-owned enterprises (SOEs), as well as the unregulated and opaque parastatal organizations ("*bonyads*" or religious foundations), which operate as conglomerates receiving substantial implicit and explicit government subsidies. Ironically, perhaps, these foundations also highlight one of the most notable contradictions of Iran's post-revolutionary populism: despite the veneer of religious probity, they have enabled a new elite to emerge which accumulates wealth through opaque and unaccountable means.

Policy outcomes depend only partially on the choice of policies adopted. The manner of their implementation too has an important bearing on economic performance, and in this respect, too, Iran's experience has been adversely affected by the post-revolutionary institutional setting. Key in this context was both the legal framework discussed above, as well as intensified political strife in recent years.

During the Third Plan, for instance, fractured internal politics and factionalism spilled over into several key areas leading at times to gridlock in decision making. Perhaps most notable was the struggles over the Foreign Investment Law, which became the site for intense wrangling between the (reformist) legislature backing the amendment to the anachronistic 1955 Law and the conservative Guardian Council

²¹ This body is made of six clergymen appointed by the Supreme Leader and six laymen selected by the head of the judiciary chief. The latter are subject to parliamentary approval.

which opposed it in many ways. The law was finally approved in 2002, following intense debates over such basic, yet fundamental, aspects of policy that impinged on Iran's place in the global economic system.²²

It is not surprising that despite this important step for stimulating foreign investment, persistent uncertainty continues to mar real flows of investment and Iran's ability to attract Foreign Direct Investment (FDI) has been notably weak: average annual FDI inflows amounted to \$326 million in the period 2000-04 or to less than 3% of all FDI inflows into the MENA region. This is in sharp contrast with Turkey, for instance, which has a similar population size but has succeeded in attracting six-fold the volume of FDI for Iran (\$2 billion). Most of MENA region's FDI is concentrated in North Africa (40%) and the GCC States (21%) which have economies that are much more open than that of Iran (even smaller countries like Morocco have attracted four-times as much FDI as Iran).

Allowing for the fact the MENA region as a whole is still severely underrepresented in global FDI flows (accounting for 1.3% only of the world's total inflows and 5.5% of the FDI inflows into LDCs), it is clear that, realistically, Iran has a long way to go to create a welcoming and reassuring environment for the attraction of such investment.

In several other key areas, too, the adoption and implementation of reforms have been impeded by the institutional setting. The divestiture of State-owned Enterprises (SOEs) was, for instance, a major objective of the Third Plan. Although the required legislative and regulatory environments were put in place during the Plan years, the pace of privatization in Iran has nevertheless been very slow and the process is still in its infancy. Indeed, privatization has so far been limited to sales of government equity shares to private investors and *bonyads*, with the majority control retained by the government. Given that SOEs are politicized institutions in which both workers and managers strive to prolong subsidies and perpetuate their redistributive function, this was perhaps largely predictable (Alizadeh, 2003).

Another area of reform with modest outcomes is the setting up of the Oil Stabilization Fund (OSF) in 2000 (see Section 4.3 above). This was ostensibly to allow the government to manage its finances more independently of fluctuations in oil prices. This is clearly a step in the right direction, since in practice favorable oil prices, have allowed the government to divert its excess revenues from the oil windfalls for purposes other than short-term budgetary needs (such as drawing down foreign debt).

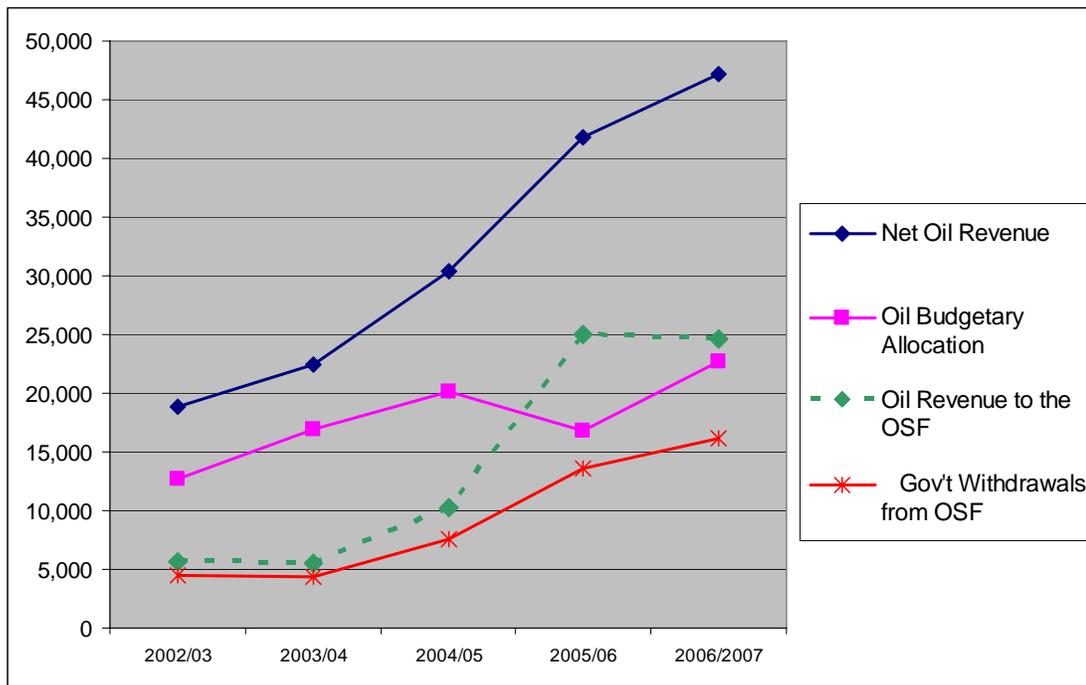
Although the OSF funds are also used to encourage and promote private sector development projects, it is nevertheless primarily set up, and acts as, a facility for managing fluctuations in the oil income and to soften its impact on government budgets. It is, therefore, different from long-term development funds (such as Kuwait), set up more explicitly as a source of savings 'for the future generations'.

Unsurprisingly withdrawals from Kuwait's fund tend to be more recurrent and politically charged or controversial in Iran. This can come about in two ways: indirectly, by the projected oil prices built into the budget (oil allocations to the OSF are a residual saving after budgetary allocations have been made); and more directly through withdrawals for special purposes. Given that this requires parliamentary approval, such negotiations can become effectively a source of strife and faction fighting between the executive and the legislature.

Figure 8 below shows the operation of OSF in practice since its introduction. It can be seen that despite healthy and rising oil revenues, oil budgetary allocations have followed a more cautionary path in recent years. However, in practice, subsequent withdrawals from the OSF account for further government financing have also increased consistently (by three-fold, up from about \$5,000 billion in 2002/03 to reach an estimated \$15,000 billion for 2006/07). On average, about 70 percent of the annual oil revenue accrued in the OSF account were withdrawn for further government financing during the period 2002-06 (as a proportion of the OSF reserves, this proportion was about 64 percent).

²² At the heart of these were: the definition of 'foreign investor' (and whether it included Iranian expatriates); ownership of immovable property by foreigners; the ratio of foreign ownership, as well as areas permissible for foreign investment; etc (Hakimian, 2003).

Figure 8: Iran's Oil Stabilization Fund (2002/03-2006/07)



* Figures for 2005/06 and 2006/07 are projections.

Source: IMF.

6. Summary and Conclusions

With more than two and a half decades after the Revolution, the structural features of the Iranian economy are remarkably unchanged: a state of severe oil-dependency continues; the general investment climate is weak and beset by uncertainty; public finances are fragile; and the economy continues to be inward-looking and unsure of its position in the wider international economy.

Macroeconomic performance during these two and a half decades has inevitably borne out some of the internal tensions and external dislocations experienced by the Iranian economy as Iran has emerged through cycles of populism and pragmatism driven by vicissitudes in the international oil market.

Internationally, Iranians have witnessed a considerable retrogression in their living standards measured in GDP per capita terms and compared with other countries with similar or even lower initial conditions at the end of the 1970s. The domestic economic setting too has been marked by an uneven, and generally disappointing, set of economic fundamentals over the three sub-periods studied in this paper. The purpose of this paper has been to highlight Iran's macroeconomic challenges, the broad policies adopted by the government in response to different external and internal conditions and the general economic track record since the fall of the Shah.

We have seen that debate over the nature and direction of economic policy in Iran has intensified - not subsided - in recent years. We have also seen how through three ostensibly different phases, Iranian policy makers have confronted specific challenges in each period: from external war to reconstruction and

reform; from foreign debt and currency crises to austerity and consolidation of the economy during peace time, and more recently to the modest structural reforms introduced under the Third Plan (2000-04).

While differences have been substantial and this paper has highlighted many, they should not mask the constancy of the challenge faced by the Islamic Republic since its inception: the need for achieving clarity and consistency over the very direction of economic policy and the system that has been shaping up in Iran since 1979. It is clear that persistent cycles of slow growth and high inflation in the Iranian economy cannot be resolved without contemplating more fundamental institutional changes and a reform of the system of governance.

But whether and when these challenges can be successfully met will depend only partially on the design and adoption of appropriate economic policies, important though these are. The experience of economic reforms in Iran both under the First and the Third Plans (when there were bouts of growth) points strongly to the need for an equally far-reaching and comprehensive package of political and institutional reforms. Delaying these reforms can only add to the eventual costs and pains of future adjustments.

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