

Statement of Kenneth Katzman

Specialist in Middle Eastern Affairs
Congressional Research Service
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Thank you, Mr. Chairman, for inviting me to appear at today's hearing. I request that the full statement be placed in the record, and I will summarize my remarks.

Overview of Iran's Political Economy

As a longtime analyst of the politics of Iran, I will primarily focus on the politics of Iran's economy. I want to preface my remarks by saying how difficult it is to obtain authoritative information on Iran's political economy. Iran is not an isolated country - it has relatively open trade with U.S. allies. However, Iran's economy is not transparent and there is no U.S. Embassy in Iran to follow Iran's economy and obtain authoritative information. The Iranian government has not, to date, allowed a CRS visit to Iran on the grounds that CRS is part of the U.S. government.

In particular, I will discuss how key leaders and factions have gained a substantial measure of control over major segments of the Iranian economy, avoiding virtually any official transparency or accountability. Iran's leaders are able to steer the proceeds of parts of the economy to provide patronage and build their constituencies, particularly among the lower classes. Because Iran's political leaders benefit from the structure of the economy as it is, there is little chance under the current system of major, structural economic reform.

The consensus of experts is that Iran's economy has improved substantially over the past two years, but that is primarily the result of increased oil prices and masks underlying weaknesses that would likely be revealed were oil prices to fall significantly. Oil revenues account for about 80-90% of Iran's export earnings and almost 50% of the government budget. The IMF, the World Bank, and outside experts say that Iran has pursued only limited structural economic reform and that Iran needs to reform its financial sector and privatize state-owned industries, and further liberalize trade regulations. As is also true of other countries in the region and throughout the developing world, some reforms are blocked by powerful political interests, and others are not implemented because of fear of mass unrest. In the case of Iran, some of its economic difficulties have been caused by the ideology of the Islamic revolution of 1979, which propounded self-sufficiency and an end to Iran's dependence on and perceived manipulation by great powers.

Energy Subsidies. As one example of Iranian mismanagement of its energy sector, Iran heavily subsidizes gasoline costs to consumers. Gasoline costs only about 40 cents per gallon in Iran, and the Majles (290-seat elected parliament) has consistently rejected proposed legislation to reduce the gasoline subsidy because doing so would result in higher prices, which could spark unrest. Iran's refining capacity is sufficient to fulfill only about 60% of the gasoline consumption of Iranian consumers, and the remainder is purchased from nearby sources (including India and Kuwait) on the open market. As a result, Iran's government is currently spending an estimated \$5 billion per year to import refined gasoline, and the funds have been

derived by drawing down on Iran's foreign exchange reserve fund. It is a large increase over the amounts spent in previous years - about \$1.5 billion per year. Most experts believe that Iran should eliminate the gasoline subsidy in order to reduce domestic demand, in part by encouraging use of public transportation. In addition, according to press accounts, Iran's per-vehicle gasoline consumption is relatively high because many of its vehicles are older-model and not fuel efficient.

Inefficient Social Welfare Policies. A 2003 World Bank assessment notes that the Islamic regime has pursued a "social justice" policy since it took power in 1979.¹ The official welfare effort has succeeded in reducing the proportion of the population below the poverty line from 47% in 1978 to 19% in 2003. The regime has also closed a gender gap in education (even though the regime is perceived as repressive of women), and it has instituted universal education and extensive health care coverage.

Over 7 million Iranians (about 10% of the population) benefit from the government's officially-sanctioned social welfare network. The main official relief agencies are the Welfare Organization and the Imam Khomeini Relief Committee. They are overseen by the Ministry of Welfare and Social Security. The Imam Khomeini Relief Committee is said to assist as many as 7 million Iranians with basic foods. The Welfare Organization, as well as the Committee, provides social welfare services to women-headed households as well as other recipients. The Ministry of Welfare and Social Security has set up some 7,000 job centers for women heads of households, providing vocational training among other services. Other ministries that oversee or give out social welfare benefits are: the Ministry of Housing and Urban Development; the Ministry of Agricultural Jihad; and the Ministry of Labor and Social Affairs.

However, the government's social welfare strategy includes the provision of implicit subsidies, not only for gasoline but also for medicines, bread, and other goods. The World Bank calls these subsidies "untargeted and ineffective" and not disproportionately benefitting the poor. Much of the benefit of subsidies goes to Iranians who are middle class or even affluent. For example, the Imam Khomeini Relief Committee also provides marriage dowries, as well as education assistance to about 600,000 students, including university scholarships. These benefits do not necessarily go to Iranians who are below the poverty line. In addition, according to critics, the government is trying to eliminate poverty through handouts and charitable transfers rather than by generating employment. The Bank recommends that Iran should shift away from untargeted subsidies to more targeted subsidies that benefit the genuinely poor.

Quasi-State Foundations (*Bonyads*). Part of this inefficiency might be a result of the politics of Iran's social welfare system. As discussed below, many Iranians receive benefits not only from the "official" social welfare network but also from an informal charitable network. The core of the informal network is the quasi-official "foundations" (*bonyads*) described below. These organizations are controlled by key clerics and other former or current government officials. The *bonyads* are technically not under the authority of the Ministry of Welfare and Social Security, and therefore the *bonyads*' criteria for deciding who should receive social welfare is often arbitrary, according to many observers, explaining why some Iranians who are not truly needy receive benefits. Those needy Iranians who are not well-connected or who are perceived as unsympathetic to the regime might often not receive social welfare benefits. By contrast, the official social welfare system overseen by the Ministry of Welfare and Social Security do have clear criteria and clearly stipulated benefits, for example for unemployment compensation, old age pensions, disability pensions, survivor benefits, and medical benefits.

¹ World Bank Report No. 25848-IRN. Iran: Medium Term Framework for Transition. April 30, 2003.

The *bonyads*, which are said to account for an estimated 33% - 40% of Iran's total GDP, also distort normal market forces in Iran. Some of them have existed for centuries as custodians of Shiite holy sites in Iran, and, since the 1979 revolution, have come to enjoy significant economic and political privileges. Several of the *bonyads*, the heads of which are appointed by Supreme Leader Khamene'i, control vast assets given to them by the state. Combined, they are said to employ as many as 5 million Iranians and give social welfare to perhaps several million more. These figures indicate that the *bonyads* have a large constituency and are able to build support for the regime among the working and lower classes.

Their privileges are vast, by all accounts. According to the World Bank study in 2001, the *bonyads* enjoy virtual tax exemption and customs privileges, preferential access to credit and foreign exchange, and regulatory protection from private sector competition. Using these preferences, some of the major *bonyads* have been able to carve out virtual monopolies in the import and distribution of several categories of items. Several of the *bonyads* are headed by former or current major figures of the regime, largely explaining their exemption from substantial official oversight.

The most controversial allegation about the *bonyads* has been whether or not their funds have been used to procure weapons of mass destruction (WMD) technology. This allegation has long surrounded the largest *bonyad*, the Foundation for the Oppressed and Disabled (discussed further below), primarily because this *bonyad* has been run by hardliners and former officials of the Revolutionary Guard (example, Mohsen Rafiq-Dust, a former Minister of the Revolutionary Guard). The theory underlying the allegation is that the *bonyads*, because they are not formally part of Iran's government, can operate outside official scrutiny of foreign governments, and could therefore illicitly procure equipment that might not be approved for export to Iran. During an official visit to Dubai in 1995, observers at the US consulate there told me that Foundation employees were present in significant numbers in Dubai, holding large quantities of cash which they were using to procure technology from Russian and other arms and technology brokers in the emirate. Others, however, put forward a less alarmist view of the Foundation's activities, saying that Foundation officials carry cash for the purpose of obtaining better pricing on purely civilian goods such as household appliances and paper goods.

Some sources say there might be as many as 123 different *bonyads* in Iran, but most experts focus only on the largest and best known of them. The major *bonyads* are the following:

- The Foundation for the Oppressed and Disabled (*Bonyad Mostazafin va Janbazan*). The largest and most important of the *bonyads*, it took over much of the assets of the former Shah and his associates who fled Iran after the Islamic revolution. It is headed by Mohammad Forouzandeh, the chief of staff of the Revolutionary Guard in the late 1980s and later Defense Minister. It now manages over 400 companies and factories, with a total value estimated by Iranian experts at as much as \$12 billion, and it is considered the largest economic entity after the government.² The Foundation is active in the following sectors: food and beverages, chemicals, shipping (Bonyad Shipping Co.), metals, petrochemicals, construction materials, dams, towers, farming, horticulture, animal husbandry, tourism, transportation, hotels (including two major hotels in Tehran), commercial services, and financing. It produces the best selling soft drink in Iran, called Zam Zam. The Foundation uses the profits

² The IMF estimated its value at \$3.5 billion in 2000.

from these ventures to assist 120,000 families of veterans and victims of the 1980-88 Iran-Iraq war, as well as large segments of the poor.

- Martyr's Foundation (*Bonyad Shahid*). This foundation also assists families of those killed or maimed in the Iran-Iraq war. It owns several companies involved in mining, agriculture, construction, and import-export.
- The Shrine of Imam Reza Foundation. Based in Mashhad in northeastern Iran, it used donations from 8 million pilgrims to the Shrine of Imam Reza to buy up 90% of the arable land in its area. The estimated value of this land could be as high as \$20 billion. The largest employer in Khorasan Province (Mashhad is its capital), the Foundation runs 56 companies, including a Coca-Cola factory and two universities, and it is said to have diversified also into automobile manufacturing. It is headed by Ayatollah Abbas Vaez-Tabasi, who is on the powerful Expediency Council that is headed by former President Akbar Hashemi-Rafsanjani. Vaez-Tabasi's son is married to a daughter of Supreme Leader Khamene'i.
- The Noor Foundation. It reportedly imports sugar, pharmaceuticals, and construction equipment, and has substantial real estate holdings. It is headed by Mohsen RafiqDust, the first Minister of the Revolutionary Guard and who later was head of the Foundation of the Oppressed. RafiqDust is on the Expediency Council.
- 15 Khordad Foundation. In 1989, it offered \$1 million to anyone who killed Salman Rushdie, author of the Satanic Verses that Ayatollah Khomeini called blasphemous. The Foundation is named for the date in 1963 when Khomeini began revolutionary activities against the then Shah.
- Housing Foundation (*Bonyad Maskan*). This foundation was set up in the months after the February 1979 Islamic revolution to provide housing for the poor, particularly in rural areas.
- Ahl al-Bayt Foundation. Said by observers to be run by younger-generation clerics.
- Isargaran Foundation. Said to be controlled by ex-Revolutionary Guard officers, it provides services to the families of those killed or taken prisoner in the Iran-Iraq war.

The Cooperatives. The so-called "cooperatives" are another sector of the economy that have come under the control of key elites. There is a Ministry of Cooperatives that, in theory, oversees the operations of cooperatives. However, in practice, the larger cooperatives are run by allies or relatives of regime heavyweights and therefore the Ministry's oversight powers are limited.

The most well known cooperative, and which exemplifies the privileged status of these organizations, is the Rafsanjan Pistachio Growers Cooperative. It is run by the cousin of former president Akbar Hashemi-Rafsanjani, who is chairman of the powerful Expediency Council. The cooperative claims to represent over 70,000 pistachio farmers. The pistachio export industry in Iran is valued at an estimated \$746 million. Rafsanjani's older brother, Ahmad, headed the Sarcheshmeh copper mine complex, although he is now retired. The control over these sectors has given Rafsanjani substantial opportunities for patronage, although obviously his wealth did

not prevent his loss in the 2005 presidential election. Some believe it was partly his wealth that caused his defeat because he is viewed as corrupt and less in tune with the interests of the lower classes than is Ahmadinejad.

The Revolutionary Guard. Some have noted that the Revolutionary Guard - the part of the armed forces that is most loyal to the clerical leadership - is playing an increasing role in the economy. President Ahmadinejad was a commander in the Guard during the 1980-88 Iran-Iraq war and his presidency is likely to only enhance the Guard's influence. Its motivations for expanding its economic role are apparently to provide rewards for senior officers, and to generate revenue to supplement the budget allocated to the Guard by the government.

The Guard has formed contracting firms to bid on government projects, using its strong political influence to win business. In one recent example, one of the firms owned by the Guard, called "Ghorb," is being awarded a \$2.3 billion deal to develop two phases of Iran's large South Pars gas field. Most of the other phases have been awarded to well-known multi-national energy firms, and the work given to Ghorb had originally been awarded to Norway's Aker Kvaerner, but was re-tendered.³ This suggests that the Guard exerted political influence to win the contract and take it away from what most industry experts would consider a more capable firm. Two years ago, the Guard briefly closed down the new international airport in Tehran to oust an Austrian-Turkish firm from some airport operations; those operations have now been taken over by the Guard.

The Politics of Economic Reform

Many Iranian officials acknowledge the weaknesses of Iran's economy, and argue for reform. However, differences among Iranian leaders – in part caused by their different constituencies – undoubtedly has contributed to the relative deadlock on broad structural reform of the economy.

Some of the differences were exposed in the course of the 2005 presidential election campaign, which resulted in the second round victory (June 24) of hardline Tehran mayor Mahmoud Ahmadinejad. He became the first non-cleric president since 1981. Ahmadinejad campaigned on a platform of redistribution of wealth to the poorer classes, rather than a growth-oriented strategy. He and his allies tend to favor an extensive state role in the economy, including state management of factories and other entities that can provide employment for the working classes. Since taking office, he has tried to implement those promises by proposing a "marriage fund" to provide monies to newly-married couples, as well as increasing some pension and other social welfare payments run by the state. He also has authorized below-market rate lending and debt cancellation for farmers.⁴

As a former Revolutionary Guard officer himself, he is close to other former Guards and those who run the various *bonyads*, particularly the Foundation of the Oppressed and Disabled, and he supports their work in distributing social welfare to the poor. He does not favor eliminating the preferences that the *bonyads* enjoy because he depends on the *bonyads* to provide social payments to his core lower class base.

³ Kalantari, Hashem and Sally Jones. Iran Set to Award Lucrative Gas Deal to Elite Militia. *Wall Street Journal*, June 29, 2006.

⁴ Diehl, Jackson. Deft Demagoguery in Iran. *Washington Post*, May 7, 2006.

He is also less attracted than are other Iranian politicians to greater economic interaction with Europe and other Western countries, for example by joining the World Trade Organization⁵ or reaching a free trade agreement with the EU (currently being negotiated). Ahmadinejad believes that his lower class constituents would not necessarily benefit from a more export-oriented, growth-oriented economy, and the lower classes generally do not buy European-made luxury goods that constitute a growing portion of Iran's imports.

Ahmadinejad's main competitor in the 2005 election, Rafsanjani, represented another pole in the debate over economic reform. Rafsanjani is a Khomeini disciple who has been a leading figure since the revolutionary regime was formed. As one of Iran's richest men, Rafsanjani believes Iran would benefit from a free trade agreement with the EU that would open up big markets to increased volumes of Iranian exports.

Another large economic interest that carries substantial weight in Iran are the bazaar merchants ("the bazaaris"). The bazaaris control not only an important engine of Iran's economy – the import and export of goods, but several newspapers, including the well-known *Resalat*, are considered their mouthpiece. They also have the ear of Supreme Leader Ali Khamene'i, who has been supportive of the bazaaris throughout his career. The bazaaris and their allies tend to oppose a large role for the state in the economy. Like Iranian reformers, the bazaaris want increased trade with the West, because doing so would expand the market for Iranian goods. However, the bazaaris do not necessarily want a completely open trading regimen that might impinge on their privileged trading status. The bazaaris are also skeptical of increased foreign investment, because Western factories and companies might operate more efficiently than Iranian companies and compete effectively with the bazaaris. Some Iranians complain that the bazaaris try to control certain markets by acting in concert, such as jointly boycotting supplier companies to force them to make concessions.⁶ Some experts refer to practices like this as "crony capitalism."

The Energy Sector

Iran's energy sector is undoubtedly the most closely watched portion of the Iranian economy, because of the dependence of the economy on its revenues. Since the Islamic revolution, Iran's energy sector has been deteriorating primarily because of antiquated practices and equipment. Oil production fell from 6 million barrels per day (mbd) in 1974, when the Shah was in power, to about 3.9 mbd since the 1979 revolution. Of that amount, Iran exports about 2.4 mbd. Iran's proven oil reserves are about 128 billion barrels, about 10% of the world's total. Its natural gas reserves are even more noteworthy - about 940 trillion cubic feet, second only to those of Russia. In the mid 1990s, Iranian leaders acknowledged that halting the deterioration of the oil sector and developing the unexploited gas sector would require foreign investment by the world's major energy corporations.

To develop the energy sector, Iran has been able to work around its ideology to attract substantial foreign investment. In 1996, Iran first offered various onshore and offshore oil and gas fields to foreign investment under a "buy-back" arrangement, in which the investing firm(s) incur all development expenses and are paid back, plus given a fixed rate-of-return, from the proceeds of the field once it becomes productive. This arrangement enabled Iranian leaders to claim that they had not compromised Iran's sovereignty in allowing the foreign investment.

⁵ Iran applied to join the WTO in May 2005 when the Bush Administration dropped its nine-year long objection to Iran's application.

⁶ Birch, Nicholas. In Iran, It Pays to Be a Religious Leader. *Seattle Times*, August 20, 2003.

Iran's buy-back offer has attracted significant foreign investment, despite Congress' enactment in 1996 of the "Iran-Libya Sanctions Act" (P.L. 104-172). That law, extended for another five years in 2001, imposes sanctions on foreign companies that invest in Iran's energy sector. However, the Clinton and Bush Administrations have not imposed any actual sanctions on investing firms, perhaps causing foreign firms to minimize the importance of this U.S. law in considering whether or not to invest in Iran.

Since 1997, when the first foreign investments began under the buy-back plan, foreign companies have committed to at least \$15 billion in foreign investment to develop about a dozen Iranian oil and gas fields. The earliest of the investments have begun production, and the more recent investments are under development and expected to begin producing oil and gas soon. Iran says that it expects these investments to increase its oil production to about 5 mbd by 2009, and 7 mbd by 2024.

Most of the natural gas produced by the new investments has been used for the domestic market or for re-injection to Iran's oil fields to boost production of oil, although it is exporting gas to Turkey through a joint pipeline. Iran is hoping to become a major gas exporter and, over the past year, Iran has signed a number of long-term (25 year) agreements with gas buyers, particularly in China and India. Iran is also in discussions with India and Pakistan for the construction of a natural gas pipeline that would link the three. The Bush Administration has publicly "expressed concern" about the pipeline, a stance consistent with U.S. policy of opposing energy routes that include Iran.

Conclusion

The current confluence of political interests and factions in Iran will likely prevent any substantive economic reform. The connections between the various *bonyads*, the Revolutionary Guard, and the upper reaches of the regime are too strong to permit curbing their influence in the economy. At the same time, the economic strength of the *bonyads* and the cooperatives translate into political strength for the clerics and politicians that run them. The income generated by these quasi-state economic conglomerates give the clerics substantial opportunity for patronage and keeps the Iranian public dependent on them for social welfare. On the other hand, these economic mechanisms are keeping Iran's poor fairly well sustained and, in the view of some, represent useful and necessary institutions even if they reduce the transparency of Iran's economy.

