

**SEMIRA N. NIKOU**

E-mail: snikou@usip.org

Phone: 202.429.4740

Iran's Subsidies Conundrum

Summary

- Iran has subsidized petroleum products, basic foodstuffs, medical goods and utilities since 1980, first to manage hardships during the eight-year war with Iraq, and then to prevent political and economic challenges after the war.
- Since the 1990s, three presidents have tried to cut back subsidies that are now estimated to cost Iran between \$70 billion and \$100 billion annually. President Mahmoud Ahmadinejad won parliamentary approval for a controversial plan to phase out subsidies by 2015.
- Under the plan, universal price controls are to be replaced with small cash payments to families and direct support of industries. Some economists are concerned that lifting price controls will trigger dramatic rises in inflation and unemployment.
- The cutbacks come at a time the government already faces serious economic troubles and tougher international sanctions. For the public, the change is likely to produce the most economic disruption since the revolution. Economic reforms have triggered unrest in the past.
- If reform succeeds, however, the program could help reduce waste, shrink state outlays and enhance efficiency and productivity.

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Overview

The 1979 revolution was carried out in the name of “the oppressed,” and the Islamic Republic has been a welfare state committed to “social justice” ever since. The government introduced rationing soon after Iraq’s 1980 invasion generated new economic hardships. To appease a war-weary society after the conflict, the theocracy kept consumer prices for energy, basic foods, medicines and utilities (water, power and sewage) well below market prices. But the economic burden soared as the new theocracy initially encouraged population growth, which almost doubled the population from 34 million to 62 million in a mere decade. The cost of subsidies, in turn, also soared.

The Islamic Republic has long been vulnerable economically. Politicians in both the executive and legislative branches have been reluctant to take badly-needed reforms for fear of political backlash. President Hashemi Rafsanjani’s austerity plan in the early 1990s sparked riots across the country, forcing him to shelve free market reforms and subsidy cutbacks. President Mohammad Khatami was unable to mobilize support from conservatives in parliament for either subsidy reforms or a plan to gradually increase gasoline prices. Under Ahmadinejad, the announcement of gasoline rationing triggered unrest and attacks on gas stations in 2007.

Ahmadinejad proposed new subsidy reforms in 2008, but the plan was deferred until after the 2009 presidential election. He had to wage a heated political battle, and a compromise was

eventually reached with the intervention of the supreme leader, in 2010. Yet for the first time, Iran's major political factions agreed that the burden of subsidies was unsustainable, despite fears of severe economic and political consequences.

The Case for Reform

Subsidies have been costly. They were estimated to eat up around 25 percent of Iran's gross domestic product (GDP) of \$335 billion in 2009. Subsidies for energy products alone accounted for 10 percent of Iran's GDP in 2010, according to the World Bank. Iranians pay as little as 38 cents for a gallon of rationed gasoline, cheaper than bottled water. Gas costs 10 cents per liter, while a liter of bottle water costs around 25 cents.

Without reforms, costs would only continue to grow as Iran's population increases—even though innovative programs by previous presidents brought the population growth rate down, from a height of 3.9 percent in 1986 to 1.3 percent in 2008. In 2010, as he was simultaneously pushing subsidy reforms, Ahmadinejad also called for new population growth, including a \$950 incentive for each new baby and a \$95 annual stipend until the child turns 18. But a higher birth rate would be a further drain on the economy, and even conservatives moved to block institutionalizing his initiative.

The subsidies program has been plagued by two fundamental flaws. First, cheap prices have fostered wasteful behavior. Iran's energy consumption has increased five-fold in the past 30 years, while the population has only doubled, according to former International Monetary Fund economist Jahangir Amuzegar. Official Iranian figures claim energy consumption has actually increased nine-fold since 1976. Cheap gas has, in turn, contributed to chronic pollution, environmental decay and massive traffic overload in urban areas.

Second, subsidies have helped everyone, not just the poor. Those benefitting the most from subsidies are middle and upper income Iranians. Iran's richest 30 percent have reaped the benefits of 70 percent of government subsidies, according to Iran's ministry of economics and finance.

The Plan

- Subsidies will be phased out over five years, ending in 2015.
- The government can cut back up to \$20 billion of subsidies within the first year. In subsequent years, parliament will have to approve additional amounts through the annual budget process.
- Immediate cutbacks affect the price of petroleum products, wheat, rice, cooking oil, milk, sugar, postal services, as well as airline and railway services. The government has discretion on which subsidies to cut first.
- Medical services and products are not affected by the plan.
- In lieu of subsidies, the government will distribute small sums of cash to individuals.
- A new government body—a subsidy reform organization—will hold most of the funds that were once allocated for subsidies. It will plan and supervise the distribution of cash payments as a substitute for subsidies. Parliament insisted on making the organization subject to audit.
- The funds accrued from subsidy cuts will be divided:
 - 50 percent for direct cash payments to people who qualify for aid;
 - 30 percent to industries that rely heavily on subsidies, and to improve the energy sector and public transportation;

- 20 percent directly to the Treasury to cover government costs of implementation and reduce dependence on oil revenues.

The Politics

Ahmadinejad's reform plan is widely interpreted as a policy reversal. He won the presidency in 2005 on a platform of increased social services and aid to the poor—and putting Iran's oil wealth on the dinner table. But his cash handouts did little to improve living standards or reduce growing income gaps. The purchasing power of Iranians, particularly the poor and middle class, weakened as inflation spiked, hitting nearly 30 percent in 2008, according to the Central Bank of Iran. Critics argued that Ahmadinejad's profligate spending also drained the Treasury of billions from oil revenues, while contributing little to improve Iran's aged and ailing infrastructure.

Unlike his two predecessors, Ahmadinejad initially rebuffed proposals for reform by the World Bank and International Monetary Fund. But tough economic realities apparently changed his mind. His original proposal called for an even more drastic plan to eliminate subsidies within three years.

Many economists and members of parliament argued that Ahmadinejad's original shock-therapy strategy would have dire consequences. They urged a more gradual transition to avoid a dramatic spike in inflation for families and industries that relied on highly subsidized energy supplies and already faced a competitive disadvantage due to sanctions. Parliament also wanted supervisory power over distribution of funds, which Ahmadinejad rejected. After a year of intense debates, a compromise bill—lengthening the transition and creating the subsidy reform organization (SRO), which will be subject to parliamentary oversight through its audit authority—was passed in 2010.

Potential Problems

The new scheme faces many dangers, especially in a fragile political climate following the disputed 2009 presidential election. First, the biggest danger is soaring inflation that could deepen poverty. Parliament's Research Center warned that Ahmadinejad's original plan could have produced inflation exceeding 60 percent, while the International Monetary Fund projected an increase of over 30 percent—figures the government rejects. Ahmadinejad's administration contends that the negative side effects will be transient and that the projections are based on out-of-date models.

Poverty is already a key political issue, and one reason Ahmadinejad first won the presidency in 2005 on a populist political platform. Figures vary widely, but both Iranian and U.S. sources say at least nine million Iranians live in absolute poverty, with millions more living at the poverty line. Some economists say the plan's success will depend on gradual implementation to avoid too much economic disruption.

Second, Iran's industries could also suffer. Many have been able to compete with cheap imports—despite outdated equipment, inefficient practices and international sanctions—courtesy of low energy costs. Economists contend that the 30 percent in new aid for domestic industries is not sufficient to compensate for higher production costs. Industries are already at a competitive disadvantage because of the high cost of labor and overvalued exchange rate. Further danger is a ripple effect that impacts workers in an already restive labor climate.

A 2010 report by parliament noted that Iran already has the world's 17th worst unemployment rate, out of 208 countries and territories surveyed, despite a change in the definition of a worker. In his first year, Ahmadinejad altered the legal definition of employment to include anyone who works two hours a week. Previously, employment meant a minimum of two days of work each week.

ABOUT THIS BRIEF

This Peace Brief was written in advance of Iran's subsidy reform. Currently scheduled for the end of September, the reform is one of the most debated and anticipated economic overhauls in the country. It has the potential to incur severe consequences in a country already burdened by sanctions and fraught with inflation and unemployment. At the same time, reform can potentially discourage waste, reduce inefficiencies in industries, and be a catalyst for economic liberalization. The brief was sponsored by USIP's Center for Conflict Analysis and Prevention (CAP). Semira N. Nikou, a research assistant at CAP, prepared this work.

Third, the new system for providing individual aid is wracked with flaws. The government originally decided to divide the population into three income brackets and distribute financial assistance to the bottom two. But Iran does not have an effective data-collection system on family income. Most data was gathered by self-reporting to Iran's Statistical Center, and many families do not want to disclose their assets for tax and other reasons. The government then revised its plan and indicated it would distribute cash payments to a wider segment of society. It also encouraged people with financial means to forgo cash subsidies, but over 90 percent of the population signed up for aid. Trying to remove them from the list—now or later—endangers a backlash.

Sanctions Impact

The United Nations, the United States and the European Union all imposed tough new sanctions on Iran in 2010. One big unknown is how they may intersect with or impact the new subsidies cutbacks.

The regime is calculating that reducing subsidies and increasing petroleum prices will force consumers to change excessive consumption habits, thereby mitigating the effects of sanctions. Iran could also try to blame new hardships on international sanctions to divert public attention from its own controversial cutbacks. But if sanctions begin to bite, either the president or parliament could also try to delay or reschedule the phased cutbacks.

The Future

- Iran is cutting back subsidies at one of the most precarious moments, politically and economically, since the 1979 revolution. To avoid a backlash, Tehran must avoid a further drop in unemployment, a slowdown in the economic growth rate and a significant increase in inflation. The growth rate of Iran's gross domestic product is already at its lowest point since 1989, after the war with Iraq ended.
- Ahmadinejad's poor economic track record has spawned concern about his administration's ability to implement such extensive reform in ways that are not politically disruptive and economically harsh, particularly on urban middle and working classes.
- The controversy over Iran's nuclear program could produce future setbacks. The Islamic Republic faces the danger of additional sanctions if there is no agreement with the international community to resolve growing tensions.
- Subsidy reform alone may not solve Iran's chronic economic problems. To improve Iran's overall fiscal health, the government also needs to pursue structural changes and other free market reforms to reduce inefficiencies plaguing state-owned or state-affiliated industries. The government otherwise may still be forced to support key sectors that depend on the state's protection or business.



UNITED STATES
INSTITUTE OF PEACE

1200 17th Street NW
Washington, DC 20036
202.457.1700

www.usip.org

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For media inquiries, contact the office of Public Affairs and Communications, 202.429.4725