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STRUCTURAL PATRONAGE IN IRAN

IMPLICATIONS OF SUBSIDIES REFORM
FOR IRAN AND U.S. POLICY

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JANUARY 28, 2010

A REPORT BY THE CRITICAL THREATS PROJECT
OF THE AMERICAN ENTERPRISE INSTITUTE



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Structural Patronage in Iran: Implications of Subsidies Reform for Iran and U.S. Policy

“[The subsidies reform package] is the most important economic bill in the past 30 years.”¹
—Iranian president Mahmoud Ahmadinejad

Introduction

As the U.S. Congress considers sanctions against Iran's refined petroleum supply, Iran has already enacted a plan to resist such measures. Tehran has expanded its refineries, sought alternate international gasoline suppliers, and begun an attempt to reduce domestic gasoline consumption (this author and others detailed this three-pronged strategy in [an October 2009 report](#)). On January 13, 2010, Iran's Guardian Council began the last part of this defense by approving a package to reduce energy and food subsidies. Although lower gasoline consumption over the next several years will make Iran less reliant on Western gasoline imports, defending against sanctions was only one reason for subsidies reform, as the internal Iranian debate shows. Redistributing income, reducing the burden subsidies place upon Iran's economy and budget, and creating an economic environment more favorable to businesses controlled by the Islamic Revolutionary Guards Corps (IRGC) have apparently been equally important motivations. Each of these factors has direct and indirect implications for Iran and U.S. policy toward Iran.

Reformers have placed the creation of a rebate fund at the heart of subsidies reform to minimize the hardship Iran's lower classes will encounter once subsidies drop. The regime could use the fund to deny benefits to individuals it views as disloyal, thus improving its ability to combat internal unrest through nonviolent means. The debate over control of the yet-to-be-finalized agency that determines who gets rebates has already revealed tensions within Iran's ruling elite. If the economic situation

Key Points

- Although sanctions have hastened subsidies reform, the Iranian regime's desires to seize greater political power, increase the Islamic Revolutionary Guards Corps (IRGC's) market dominance, redistribute income, and lessen budgetary pressure have provided critical motivations for reform.
- Subsidies reform will make Iran's economy more hostile to businesses not linked to the IRGC, increasing the economic control exerted by the IRGC in recent years.
- The rebate program at the core of Iran's subsidies reform package will give President Mahmoud Ahmadinejad additional ways to reward political loyalists while curtailing or denying benefits to regime opponents.
- Both the increased IRGC economic role and the rebate program could distort Iran's economy over the next several years, perhaps more quickly than sanctions could, while disproportionately harming Iran's opposition.
- Subsidies reform in Iran necessitates that the United States develop two long-term strategies, one for dealing with a potentially more hostile, authoritarian Iran home to a disenfranchised opposition and one for dealing with an increasingly distorted Iranian economy.

deteriorates further and the regime does not adjust the rebate program flexibly, the program could exacerbate those tensions and alienate the business class and urban elite further from the regime.

President Mahmoud Ahmadinejad could work to mitigate that risk by expanding the rebate program to provide more benefits to the middle and upper classes. Such a shift would defeat many of the main objectives of the rebate program, however, including relieving some of the strain on the government's finances.

Decreased energy subsidies will also likely increase already-high production costs for small-and-medium-size businesses in Iran. Corporations with IRGC connections will more easily weather subsidies reductions because of their larger size, access to government capital and military materiel, and revenue from black market activities the IRGC and its allies largely control. Subsidies reform is thus likely to increase the de facto nationalization of the Iranian economy (which the regime already controls substantially through the *bonyads* and IRGC economic activities) and to concentrate even more economic power in the hands of the IRGC.

Subsidies reform is one of the largest domestic policy changes in the history of the Islamic Republic. Its goals include not only mitigating the effects of international sanctions on the sale of refined petroleum products to Iran, but also increasing the ability of the Ahmadinejad government to reward its friends and hurt its enemies through nonviolent means. The culmination of a reform campaign more than fifteen years old, today's subsidies reform will give the regime protection from external pressure, the ability to control which segments of the Iranian population suffer from sanctions, and an additional tool to confront internal opposition without directly resorting to force.

Recent Context

On January 13, 2010, Iran's Guardian Council approved a bill to reform energy and food subsidies.² While Iran's June elections have ignited a series of

antiregime protests (see analysis by Maseh Zarif on [recent December Ashura protests in Iran here](#)), subsidies reform has dominated debate among Iran's political and media elite in recent months.

Many countries, particularly oil-producing states, heavily subsidize fuel for their populations. These subsidies help ensure that all citizens benefit from the state's oil wealth, and they help placate internal economic, and sometimes, political frustration. Iran is no exception to these trends, which is why the economic and political ramifications of subsidies reform have been the focus of the internal Iranian policy debate for a number of years. Current subsidies may consume as much as a third of Iran's gross domestic product (GDP), adding increased urgency to the regime's desire to reduce the economic burden subsidies impose on the state.

The Ahmadinejad regime has adopted an approach that seeks to minimize the effect of subsidies reform on the lower classes while allowing the middle and upper classes and those parts of the business class not affiliated directly with the regime to bear the brunt of the change. For that reason, the regime intends to phase in a large rebate program as subsidies phase out.

There is a very important difference between the way a subsidy program works and the way a rebate program works. A regime generally implements subsidies in the form of price caps on the sale of selected products—in Iran's case, the caps are subject to rationing quotas. The regime has no direct involvement in determining who specifically benefits from the subsidies—everyone who purchases fuel at subsidized prices benefits. Attempting to deny subsidies to particular individuals or groups is difficult, as it requires affecting the way those who sell the product charge for it. Rebates are very different. In a rebate system, the price of the product is allowed to move closer to market price and the government decides to whom the rebates will go and how much they will be. The government can choose not to apply any filters to that process, simply mailing checks (or giving cash or credit) for a common amount to every citizen (similar to the 2008 tax-rebate program in the United

States). But the government can also choose to micromanage the delivery of rebates to an arbitrary degree. Doing so requires establishing or designating a bureaucratic entity that can tailor the rebate program based on knowledge about the particular individual under consideration. The Ahmadinejad administration has chosen this approach by creating a body, detailed below, that will supervise the rebates. It will determine how an enormous amount of government money will be used to underwrite at least part of the living costs for as many as 46.5 million Iranians, or 70 percent of the population. A natural power struggle between parliament and Ahmadinejad for control of that body has delayed passage of subsidies reform and absorbed debate over the issue.

In early December, the Guardian Council disapproved of a version of the subsidies reform it received from parliament, likely because that version mandated that the legislative, not the executive, branch control the rebates.³ Parliament argued that, constitutionally, the president could not control the rebate fund because it infringed upon parliament's responsibility over the budget.⁴ Ahmadinejad retorted that only the executive branch had the flexibility to respond rapidly to fluctuating economic conditions to protect the Iranian population and certain industries.⁵

On January 5, 2010, parliament solved the impasse by approving the creation of an independent governmental organization that would supervise implementation of subsidies reform and manage the dispersion of the rebate funds.⁶ According to media sources, parliament will oversee the new body as part of the budgetary process, with 50 percent of the funds slated for lower classes, 20 percent for infrastructure related to the agricultural and industrial sectors, and 20 percent to be controlled by Ahmadinejad for projects of his own choosing.⁷

The public welfare, economy, treasury, commerce, transportation, mines and industry, and oil and energy ministers will participate in the organization, which Iran's Supreme Audit Council will oversee.⁸ The Supreme Audit Council is run by Abdul-Reza Rahmani Fazli, who previously served as a member of parliament and, in 2007, as deputy head of Iran's

Supreme National Security Council (SNSC).⁹ Ahmadinejad loyalist Said Jalili currently heads the SNSC, a body with considerable sway close to Iran's president.¹⁰ Of the ministers named as participants, Iranian oil minister Masoud Mirkazemi, Energy Minister Mohammad Aliabadi, and Industries and Ministers Minister Ali Akbar Mehrabian are reportedly loyal to Ahmadinejad. Mirkazemi also has IRGC ties, and more of the participating ministers may have unreported connections to Ahmadinejad or the IRGC.¹¹ Despite the fact that Ahmadinejad has direct supervision over only 20 percent of the rebate funds according to this plan (which is still an enormous amount of money), his ties to those in charge of the new organization (who are, after all, his ministers) may lead to his indirect influence over the remaining 80 percent.

Ahmadinejad nevertheless signaled disappointment with the subsidies program approved by the Guardian Council. He stated that implementation of the bill as passed will take two-thirds of the government's resources, as opposed to just half that required if the original version he submitted had passed.¹² Despite the frustration he expressed with lessened direct control and the length of the subsidies debate, Ahmadinejad will likely still be able to use his allies to control the rebate fund. At all events, he remained optimistic about the bill overall, declaring on its passage: "I assure you that there will be no single unemployed or poor person in Iran in the coming three years."¹³

History of Iran's Subsidies Program

Subsidies and attempts to reform them have a long history in Iran, which helps explain the exact outlines of the current program and the reasons behind support for and opposition to reform. Iran's program of providing subsidies to decrease food and energy prices has existed for decades. After the Islamic Revolution in 1979 and the Iran-Iraq War (1980–1988) the regime established subsidies to assist war veterans, in addition to preexisting subsidies. These

TABLE 1
IRANIAN ENERGY SUBSIDIES, ESTIMATED VALUE AND SHARE OF GDP, SELECTED YEARS

Year	Energy Subsidies Value*	GDP of Iran*	Share of GDP (percent)
1994	\$11 (15.92) ¹⁵	\$67 (96.99) ¹⁶	16.42
2001–2002	\$11 (13.39)** ¹⁷	\$116 (139.43)** ¹⁸	9.48 ¹⁹
2003	\$13 (15.51) ²⁰	\$133 (155.07) ²¹	10.00
2005	\$37 (40.64) ²²	\$188 (206.52) ²³	19.68
2007	\$50 (51.74) ²⁴	\$285 (294.89) ²⁵	17.54

NOTES: *Billions of U.S. dollars in current dollars (historical dollars unadjusted for inflation); numbers converted into 2009 dollars in parentheses; numbers on subsidies value are inexact estimates from varying sources.

**Average of 2001 and 2002 numbers as Iranian calendar year does not match Western calendar year; 2009 dollar conversion achieved through average of figures converted using 2001 and 2002 rates.

Other sources say energy subsidies averaged 11 percent of Iran's gross domestic product (GDP) in the 1990s; this data indicates subsidies dipped as a share of GDP near the end of the decade.²⁶

subsidies have become an increasingly significant part of the Iranian economy and government budget since then.¹⁴ Available data, displayed in Table 1, shows how energy subsidies in particular have risen over the past fifteen years.

Current numbers for the value of Iran's energy subsidies program vary widely. Many sources place the value of all subsidies programs, including non-energy products such as food and medicine, at roughly \$100 billion, which matches accounts that indicate Iran may spend nearly 30 percent of its GDP on subsidies (Iran's estimated 2009 GDP was \$331 billion).²⁷ Energy subsidies likely comprise just over half of this sum: a 2009 article indicated that Iran spent \$35–45 billion just on fuel subsidies, which do not include other energy subsidies such as those for heating oil.²⁸ This spending eclipses Iranian trade with major partners: in 2007, Iran-China trade totaled \$20 billion and Iran-EU trade reached \$31.86 billion.²⁹

Iranian government officials have recognized this increasing burden for over a decade and a half. In 1994, then-president Akbar Hashemi Rafsanjani attempted to reduce the strain, but his attempts buckled under political pressure and a liquidity crisis in the Iranian economy.³⁰ A few years later in

1999, subsidies reform emerged again during the presidency of Mohammad Khatami as a plank in Iran's third five-year plan. Subsidies remained, however: in 1999–2000, Iran subsidized products such as gasoline, kerosene, gas oil, and fuel at as much as 74 to 94 percent of their values.³¹ Subsidies reform efforts continued to drift throughout the 2000s, hampered by competing political interests and the sort of public unrest that occurred during the government's 2007 attempt to ration fuel.³²

International recognition of the economic burden of subsidies, particularly pressure from the World Bank and the International Monetary Fund (IMF), has consistently spurred efforts at reform. A 2002 World Bank report argued that Iran should phase out subsidies to provide savings for and avoid deadweight in Iran's budget.³³ A 2007 IMF report said political pressure to keep spending high partly caused the failure to phase out subsidies. That report also argued that if the regime cut subsidies, then a rebate program could mitigate the burden placed upon Iran's poor by the resulting spike in energy prices. The 2002 World Bank report implied similar government assistance, which the bank then detailed further in a 2003 report.³⁴ Ahmadinejad's reform plan, detailed below, centers upon such a rebate program.³⁵

Current Subsidies and Outline of Proposed Reform

Iran's current subsidies program covers all of Iranian society. Iranians can buy gasoline at one of two prices: at \$0.38 per gallon (or \$0.10 per liter) under a quota of 21.13 gallons or eighty liters (the quota limit varies across sources—many others cite a quota limit at one hundred liters) per person per month or at \$1.52 per gallon (\$0.40 per liter) for all gasoline purchased after the first 21.13 gallons.³⁶

Subsidies reform supporters such as Guardian Council secretary Ayatollah Ahmad Jannati claim that 30 percent of Iranian society—the top three income deciles—use 70 percent of the energy subsidies.³⁷ A 2003 World Bank report confirmed this disproportionate share, stating that, per capita, the richest urban income quintile used subsidies benefits 6.7 times as much the lowest urban quintile.³⁸ Given that Iran has an estimated 9 million cars (as of 2008, 7 million as of 2007) for 66 million people, this figure makes sense: the upper and middle classes use vehicles much more often.³⁹ The roughly one-car-to-seven-people ratio countrywide becomes to one-to-two-and-a-half in wealthier Tehran, which has an estimated 3 million cars for 7.7 million people.⁴⁰ A 2003 World Bank report cited such data to show that the second-highest income quintile spent the most on gasoline.⁴¹ Wealthier individuals also likely use more natural gas and other energy sources in their larger homes and businesses.

Iranian families below the median income reportedly spend, on average, \$4,000 per year.⁴² Individual income in Iran also averages between \$300 and \$460 monthly or \$3,600 to \$5,520 annually. The rebate fund will target those making between \$300 and \$350 per month, according to media sources.⁴³ If the subsidies reform package reduced the quota limit from one hundred liters to fifty-five liters, as media coverage indicates, a breadwinner at the low end of the income bracket who used his full one-hundred-liter ration would see his spending on gasoline increase by \$13.50 per month or \$162 per year.⁴⁴ Spending would also increase in other areas if prices for natural gas or foodstuffs rose due to subsidies reform.

Ahmadinejad's plan thus includes a rebate program to offset the costs of subsidies reform for the lower class. As many as 70 percent of Iranians would receive some level of rebate, according to media coverage.⁴⁵ Although reports vary on the amount each individual would receive, several articles have stated that rebate amounts would average 170,000 rials or \$17 per person.⁴⁶

The Iranian government will stagger subsidies cuts over several years, rather than enacting them in whole at once. Ahmadinejad originally wanted subsidies to start phasing out with the beginning of Iran's fifth five-year development plan in March 2010 (Khatami and Rafsanjani had tied previous subsidies reform efforts to the commencement of five-year plans).⁴⁷ Although March 2015 has reportedly remained the target date for the full implementation of subsidies reform, the delay in the bill's passage appears to have pushed the initial implementation date back to April 2010.⁴⁸

Economic Effect of Subsidies Reform upon Iran's Lower Class

Subsidies reform does not necessarily portend disaster for Iran's poorest families. Using the \$17 per person rebate numbers cited above, an adult at the head of a family of four would receive \$68 per month in compensation for higher energy prices. If all four family members continued to use one-hundred liters of gasoline per month, the maximum reported quota prior to reform, the family's costs would rise by \$54, leaving almost \$14 to account for rises in heating costs.⁴⁹

This scenario is unlikely. First, a poor family in Iran will probably not use four hundred liters of gasoline per month. Wealthy Iranians disproportionately use gasoline subsidies because of higher vehicle ownership and business ties, as detailed above. Second, the actual rebate payment could be higher than \$17 per person, as the \$17 figure is probably averaged across many more Iranians than those the rebate program intends to benefit the most—the lower classes.⁵⁰

Subsidies reform could potentially increase the cost of basic goods beyond what \$14 could cover for an average Iranian. Increased production costs, resulting from the higher cost of industrial supplies such as gasoline and oil, would cause spikes in the prices of basic goods. Fearing such price spikes, Iran has begun stockpiling commodities such as food, milk, and other products to distribute to poor families unable to afford basic staples as subsidies phase out.⁵¹ If the rebate fund administrators do not increase the monthly payouts as prices rise and the commodity reserve fails to serve enough Iranians, families depending upon a fixed-income from rebates could face hardship.

Higher production costs could also spur greater inflation, which could harm poor Iranians if their incomes and rebate checks do not rise proportionately. Many reform critics have cited such an eventuality, with some claiming inflation could rise as high as 60 percent.⁵² Price increases in the costs of basic goods could lessen demand, creating a deflationary effect. Gasoline consumption, for example, could fall, as smugglers currently resell huge quantities of petroleum products at higher prices in neighboring countries such as Iraq and Pakistan, an activity that could lessen if gasoline prices increase and quotas decrease.⁵³ Iranians, however, require a certain amount of gasoline for daily tasks such as transportation and business; therefore, gasoline demand will not drop below a certain level, at which point gasoline demand would be price-inelastic. Demand for other goods targeted by subsidies—such as food and heating oil—is likely much more price-inelastic, meaning consumption may remain relatively unchanged after subsidies reform increases prices. An inflationary effect could result if, after subsidies reform, gasoline consumption remains relatively high and Iranians continue to purchase food and bread at higher prices at demand levels similar to those prior to reform.

Iran's current inflation rate is 13.5 percent, down from a high of 30 percent in October 2008 and a 2008 average of 25.4 percent, a year when the Central Intelligence Agency (CIA) ranked Iran as one of the ten most inflationary countries in the world.⁵⁴ Any inflationary pressure resulting from subsidies reform

would add to that already created by Ahmadinejad's high governmental spending on cash handouts, housing, infrastructure, and other initiatives.⁵⁵ Additionally, Iran's interest rate remains relatively inflexible. The Economist Intelligence Unit estimates its 2010 nominal lending rate at 12.5 percent, and Iran's interest rates have stayed between 12.5 and 12 percent since 2007.⁵⁶ A failure to increase the interest rate could allow inflation to climb as the money supply increases. Indeed, Iran's broad money supply (M2) grew significantly last year, 24.7 percent year-to-year in August 2009, as oil prices rebounded; in contrast, the U.S. M2 rate climbed over 10 percent only a few times in the last decade, topping out at 10 percent year on year growth in late 2001.⁵⁷ Further increases in the Iranian money supply and oil prices could spur greater inflation.⁵⁸

The regime has already begun to enact measures it believes will reduce inflation. On January 21, Deputy Finance Minister Ashgar Abolhasani banned bank account withdrawals over 150 million rials (roughly \$15,150), in an apparent attempt to reduce the amount of available cash in the Iranian economy or, potentially, a run on deposits in Iranian banks.⁵⁹ On the same day, Ahmadinejad said his government would remove three zeroes from the Iranian rial, currently valued at approximately 9,900 rials to the dollar, due to perceived devaluation.⁶⁰ The government has not said whether it will issue new rials to replace old lower-valued rials.

In response to price and inflation fears, reform supporters have designed a rebate program that could soften the blow of higher prices for the poor. If rebate rates adjust to unforeseen price hikes or greater inflation, and if the transition proceeds smoothly, the available numbers for average income and the scale of targeted rebates indicate that Iran's poor may be able to avoid severe hardship under the reform plan, at least in the short term.

Reasons Cited in Support of Subsidies Reform

Indeed, regime allies have called for subsidies reform as a way to assist the poor. Beyond the increasing size

and proportion of subsidies in Iran's economy, many supporters cite the fact that the upper and middle classes receive significant benefit under the current system. Jannati and Ahmadinejad, for example, have cited figures that show that the wealthy use the majority, roughly 70 percent, of subsidies.⁶¹ Iranian interior minister Mostafa Muhammad Najjar stated that the rich are unfairly taking advantage of the subsidies program.⁶² Those with greater income likely consume more, and those who consume more benefit more from the price breaks generated by subsidies. This statistic thus serves as one of the primary talking points in a populist-oriented subsidies reform message. As Ahmadinejad says:

However, our research during the last 50 years shows that the tenth stratum, who are the richest people—God grant them health, thanks to God, and God grant that everybody reaches this level—these people consume energy over 30, 35 times more than the first stratum does. It means that the subsidies that we allot exceed the consumption of the lowest stratum for [sic] 35 times. Is it fair?⁶³

On December 3, Ahmadinejad stated: "I believe if we carry out the project of targeted subsidies, we will have no poverty in the country."⁶⁴ Ahmadinejad has stated that the aim of the subsidies reform is to have everyone live like the top three deciles of Iranian society.⁶⁵ The rebate fund would attempt to achieve this goal by going beyond existing government subsidies, benefits, and grants to the lower classes, which increased in value from \$11 billion in 2005–2006 to \$25 billion in 2008–2009.⁶⁶ Ahmadinejad won the election in 2005 promising to improve the condition of the lower classes; subsidies reform, delivered early in his second term, would continue and greatly multiply the increasing allocation of government funds to Iran's poor.

Ahadinejad also urges reform to eliminate what he sees as inefficiency in the current subsidies system, claiming that 20 to 30 percent of subsidies money goes to waste because government spending on

subsidies provides less value than a system in which consumers could buy directly from producers.⁶⁷ Ahmadinejad claims that he seeks to redistribute, rather than remove, subsidies to increase efficiency.⁶⁸ Ahmadinejad and his allies see Iran's energy consumption as the primary manifestation of such waste:

[The amount of oil consumption] is equal to the volume of the consumption in countries which have 15 times more population and whose economic production exceeds Iran's production several times over. I mean we consume a lot. No country in the world consumes like we do.⁶⁹

Even those conflicted about the subsidies reform plan agree that energy consumption is too high in Iran. Shahriyar Taherpur, a member of parliament from Toyserkan, stated that it takes 260 tons of "energy" to produce 1 million dollars worth of goods in Iran compared to only 150 tons in Saudi Arabia.⁷⁰ A 2003 World Bank report also revealed this disparity, showing that the energy costs of good production were higher in Iran than in other countries—for example, producing a refrigerator in Iran required 70 percent more energy than that used in the international "best practice" production of refrigerator models imported into Iran.⁷¹

The graph below shows that, as of two years ago, Iranians consumed far more gasoline per person than any of their neighbors, using almost a liter of gasoline per day per person for the transport industry, which utilizes the vast majority of motor gasoline consumption. Even Americans, who consume far more energy per capita than citizens of any other country, only consumed 4.5 times as much gasoline per capita as Iranians in 2007 (the U.S. GDP is forty-three times the size of Iran's, but the United States only uses twenty-two times as much gasoline as Iran, creating almost twice the value per unit of gasoline as Iran).⁷² Iran's neighbors across the Gulf, such as Qatar and the United Arab Emirates, do consume more motor gasoline per capita than Iran. However, the Iranian economy more closely resembles those of

TABLE 2
MOTOR GASOLINE BARRELS CONSUMED FOR ROAD TRANSPORT IN IRAN AND ITS NEIGHBORS IN 2007,
PER CAPITA

Country	Barrels per Year	Barrels per Day	Liters per Day	Population	Liters per Person per Day
Afghanistan	332,670	911	144,888	26,911,532	0.0054
Armenia	1,441,570	3,950	627,847	2,971,650	0.2113
Azerbaijan	6,764,290	18,532	2,946,049	8,120,247	0.3628
Iran	146,630,700	401,728	63,862,027	65,397,521	0.9765
Iraq	32,934,330	90,231	14,343,879	27,500,156	0.5216
Pakistan	12,223,490	33,489	5,323,693	169,121,963	0.0315
Turkey	20,770,550	56,906	9,046,192	74,767,836	0.121
Turkmenistan	7,207,850	19,748	3,139,233	4,774,232	0.6575
United States	3,161,354,480	8,661,245	1,376,863,825	301,290,332	4.5699

NOTE: All figures from 2007. 1 gasoline barrel = 158.9683 liters.

SOURCES: Motor Gasoline Consumption by Transport Industry: UN Energy Statistics Division; Population Data: U.S. Census Bureau International Data Base.

countries such as Iraq and Turkey, where populations far outstrip those of the tiny Gulf states. Higher prices explain the disparity: compared to the \$0.10 per liter Iranians pay for gasoline under the quota limit, Iraqis paid \$.035 to \$.039 per liter (as of August 2009), Pakistanis \$0.84 and Turks \$1.87 per liter.⁷³ As a result, consumption has increased steadily over the years; in the 1990s, it increased by an average of 2.8 percent per year.⁷⁴ Such disproportionate consumption has exacerbated Iran's budget problems: Iranians consume more gasoline than the government can afford to subsidize.

Subsidies reform supporters have also cited preemptive defense against sanctions as a reason for their efforts, forming the third tier in Iran's plan to defend against sanctions (this author and others [detail the entire plan here](#)). Several members of parliament and others have mentioned that subsidies reform could reduce the effect of sanctions and decrease the likelihood that the "enemy will be able to exert pressure" on Iran's gasoline consumption vulnerability.⁷⁵ However, goals to reduce the strain on Iran's budget, increase the wealth of Iran's lower class, and eliminate waste and excess corruption have been cited much more often as reasons for reform. Iran, after all, began

subsidies reform attempts fifteen years ago, long before discussions of Western sanctions against Iranian gasoline imports emerged.

Reasons Not Stated in Favor of Reform

Supporters have left unsaid some reasons for supporting reform, primarily the political power that could be gained through controlling the rebate program and the potential increase in power of the IRGC and its allies. Whoever disperses the rebates would, at least in the calculation of reform supporters, incentivize millions of Iranians to support their new benefactors. If the rebate program covers 70 percent of Iranians, then the potential loyalty of roughly 46.5 million people could be at stake.⁷⁶

Beyond purchasing the loyalty of potential supporters, the rebate program could also give its controller the power to punish enemies through the denial of subsidies. Many of Ahmadinejad's supporters hail from Iran's lower classes; he achieved some of his highest margins of victory from more rural, less affluent provinces in Iran's south and east in the June 2009 elections. According to Iranian

economist and Chamber of Commerce member Jamshid Edalatian, subsidies reform could punish Iran's middle class.⁷⁷ Heshmatollah Falahat-Pisheh, a member of the Majlis, has also criticized subsidies due to their potential to create class divisions.⁷⁸ The subsidies reform program explicitly targets the urban middle and upper classes—precisely the groups that have been disproportionately involved in antiregime protests and demonstrations in recent months. Ahmadinejad's rhetoric and the rebate program's focus on the poor bear out these concerns.

Ahmadinejad may believe that he can reduce popular dissatisfaction among the lower classes, thereby reducing their enthusiasm for joining ongoing protests and opposition movements. He could also potentially use the rebate program to punish those who have demonstrated against the regime, such as students from upper- and upper-middle-class families, more subtly than through arrests and violence.

Not all Iranians see these potential advantages for the regime. Ahmad Tavakkoli, head of the Majlis Research Center, believes that subsidies reform could spur greater protest by alienating and provoking those individuals who have formed the backbone of the Green Movement.⁷⁹ As of November, Tavakkoli remained skeptical of the subsidies reform, fearing that, just as the government has allegedly failed to root out corruption in the banking system, the further government control manifested in the rebate fund could spur more malfeasance. Tavakkoli does not doubt Ahmadinejad's personal honesty, but questions whether Ahmadinejad, as only one man, can defend against the efforts of "sinister people" to manipulate the new system to their advantage.⁸⁰

The regime could also use subsidies reform to punish and reward members of Iran's business class. Many of Iran's businesses use energy subsidies to lower production costs. The removal of overall subsidies would give Ahmadinejad and his administration the power to determine which businesses might receive funds to compensate for higher production costs.

Many Iranian business leaders, recognizing the resulting higher costs and potential political danger, have been outspoken in their opposition to subsidies

reform. Kordestan business leaders, such as Mohammad Najib Sharifi, say that Iranian commerce will no longer be able to compete internationally as production costs will rise and foreign competitors will offer lower prices.⁸¹ Mousa Vafayan, head of the Sari Chamber of Commerce in northern Mazandaran province, says subsidies reform would result in the shuttering of factories, of which he claims 30 percent have already closed.⁸² Former Iranian presidential candidate Mohsen Rezai has argued that subsidies reform supporters need to take the effect of the foreign economy on the domestic economy into account.⁸³ The state-linked newspaper *Jam-e Jam* even recognized the reality of higher production costs, publishing a table that estimated the costs of producing a unit of cement rising from \$128 to \$208, and the costs of producing a unit of aluminum increasing from \$65 to \$87, among hikes in production costs for other goods.⁸⁴ A 2003 World Bank report estimated similar spikes.⁸⁵

The Effect of Subsidies Reform Upon the Islamic Revolutionary Guards Corps

The administration may not want to punish all businesses, but rather just those not linked to the regime. Jamshid Assadi, an economics professor at the American University in Paris, says that the subsidies reform program would help the businesses tied to the IRGC, and hurt those without political ties, as IRGC-tied companies tend to be larger and could more easily weather higher energy prices.⁸⁶ Increasing the costs of doing business for the IRGC's domestic competition would be only the latest IRGC success in increasing its domination of the Iranian market.

The IRGC's control over the oil, gas, and construction conglomerate Gharargah Sazandegi-ye Khatam al-Anbia (GHORB) illustrates the method of such an expansion. GHORB has easier access to capital through public banks and can outbid smaller competitors due to its size and political ties.⁸⁷ Most recently, GHORB has been involved in phases 15 and 16 of the South Pars field, one of the largest

natural gas fields in the world.⁸⁸ In late December, the Iranian press reported that GHORB intended to withdraw \$1 billion from Iran's foreign exchange fund to complete its work on phases 15 and 16 of South Pars, a project that had run into delays because of a lack of financing.⁸⁹

Such action shows how the IRGC maintains competitive advantage through its ability to receive financing for its projects from government assets unavailable to other businesses. Beyond such capital access, the IRGC has played a significant role in black market smuggling, with revenues as high as \$12 billion a year according to one member of the Majlis.⁹⁰ Contraband activities will allow the IRGC to continue to receive revenue while smaller enterprises uninvolved in illegal activities will face greater difficulty without energy subsidies.

The IRGC's economic control goes far beyond South Pars.⁹¹ In 2002, the IRGC pushed Turkcell away from the Iranian market in order to protect its interests.⁹² The Iran Electronic Industries, which is under the aegis of the IRGC-controlled Defense Industries Organization (DIO), has purchased SIM cards and other technology to increase IRGC wealth.⁹³ The IRGC even has contracts for the Tehran Metro and the Tehran-Tabriz railway; both forms of public transport would experience increased demand under subsidies reform as higher gasoline prices would cause a reduction in the usage of personal vehicles.⁹⁴ Unsurprisingly, Hassan Feroozabadi, chief of the armed forces general staff (which includes the IRGC), has come out publicly in favor of the bill.⁹⁵

Conclusions for Iran and U.S. Policy

In the short term, subsidies reform will provide greater power to Ahmadinejad and his allies while increasing the IRGC's dominance of the Iranian market in the medium term, building upon the economic and political control the IRGC has amassed over the past several years. Both trends will increase the political and financial wealth of the Iranian rul-

ing class and potentially create economic instability for all other Iranians.

As the IRGC receives more contracts, the quality and timely completion of projects inside Iran, especially those related to the energy sector, will likely decrease. The IRGC lacks the technical specialization that only multinational firms can provide and has thus encountered difficulty in completing complicated projects, such as phases 15 and 16 of South Pars field, on time. As subsidies reform further eliminates domestic competition for IRGC commerce, such inefficiency will likely increase. Political ties, not competence and price, will become more important to winning bids. Although the IRGC and its regime allies may become more affluent, Iran's economy as a whole could suffer due to increased inefficiency.

As with the nuclear program, the regime could decide that the completion and quality of some projects ranks so highly that state resources need to be devoted to the effort. In its South Pars project, the IRGC attempted to use government money to compensate for its skill deficit by raiding Iran's foreign exchange fund, which had already shrunk to \$78 billion by late December 2009, \$10 billion lower than a year before. However, this strategy, when applied to projects across Iran, would rob Peter to pay Paul. Such practices would further distort the Iranian budget and economy, and reduce the ability of the government to provide services to the Iranian people.

Yet, Ahmadinejad will almost certainly not cut services. As a populist, his use of government outlays to redistribute wealth to Iran's poor anchors his political program. Members of the middle class will likely experience the most difficulty under reform, as they use subsidies more than the poor but will receive smaller rebate checks than the lower class. Some of them may join the protesters. Unlike during the government's fuel rationing attempts in 2007, when some Iranians responded by setting gas stations on fire, an antiregime core exists with grievances that extend beyond immediate economic concerns and rhetoric that directly challenges the legitimacy of the Islamic Republic.⁹⁷ To avoid such short-term fallout, Ahmadinejad may be tempted to

increase entitlements to the middle class by expanding rebate coverage. Such a move, however, would put greater strain on Iran's budget.

Increased IRGC market dominance, government bailouts for IRGC projects, and an expanding rebate program may mean that, despite its backers' intentions, subsidies reform may fail to reach its goal of reducing distortion in the Iranian economy and strain on the Iranian budget. An inefficient and beleaguered Iranian economy does not mean that the government will change policy, however. As the South Pars episode displays, the Iranian regime will continue to fund projects it believes important to its survival. The nuclear program apparently falls into this category, as do IRGC activities and proxies in the Levant, Iraq, and Afghanistan. IRGC business initiatives may increasingly achieve must-fund status as the regime decides that it needs the IRGC for protection and the IRGC decides that it needs to have a role in almost all Iranian business to provide such defense.

As the Iranian regime refuses to make hard choices to avoid aggravating Iran's middle class while assisting the IRGC, Iran's economy will likely suffer. Avoiding short-term political pain could prove counterproductive for the regime, as lesser prosperity for all Iranians will mean more Iranians with grievances against the stewards of the economy—the regime. However, Ahmadinejad designed subsidies reform to ensure that, as it phases in over the next five years, regime critics will have fewer and fewer assets with which to oppose the regime. Ahmadinejad will also likely use his power over the rebate program to selectively reward or punish individuals based on their degree of loyalty to the regime. As some reform opponents fear, Iran will increasingly become a society of two classes: a more prosperous, obedient one and an economically disconnected, dissident one.

Reportedly, the Obama administration is already moving in the direction of embracing policy options that distress regime loyalists—such as an expanded program targeting the IRGC's secondary and tertiary enterprises and regime assets located outside Iran.⁹⁸

Economic reform in Iran necessitates that, in the long term, the United States must devise two strategies: one for dealing with an increasingly authoritarian Iran, home to an IRGC close to reaching its goal of dominating the Iranian economy and an increasingly disenfranchised opposition, and a second to respond to any future distortion in the Iranian economy, which will affect Iranian foreign policy and, thus, U.S. interests.

If the IRGC perceives success in its attempts to gain greater control and if it achieves greater relative prosperity despite a less effective Iranian economy, it may act with even greater confidence in its control of the nuclear program and conduct of activities abroad. U.S. policy must prepare for the possibility of increased Iranian hostility across the Middle East and an Iranian opposition with potentially fewer financial assets.

Any future distortion in the Iranian economy will affect Iranian policies that matter to U.S. interests, including the actions of Iran and the IRGC outside Iranian borders, the nuclear program, and Tehran's treatment of the opposition movement, among others. Adopting a strategy to deal with economic instability in Iran will allow the United States to adopt a preemptive, rather than reactive, approach to responding to Iranian policies by dealing with some of the domestic factors that influence them.

As the limited availability of data on subsidies reforms shows, the United States needs to address a deficit of understanding of the distorted, politicized, and somewhat opaque Iranian economy. An understanding of the antiregime core in Iran requires knowledge of those businesses close to the regime and those opposed to it. As the IRGC increasingly becomes synonymous with the Iranian economy, a qualitative and quantitative assessment of IRGC business operations and their effects on the larger Iranian economy will also become increasingly important. Iran's economy directly affects its politics, foreign policy, and nuclear program. It is time we developed a strategy to understand and respond to its current state and future trends.

Appendix: Supporters and Critics of Subsidies Reform

Please note this is a partial list compiled from open source reporting.

Supporters

- Members of Ahmadinejad Administration
 - President Mahmoud Ahmadinejad
 - Ahmad Ayatollah Jannati, head of the Guardian Council⁹⁹
 - Mostafa Mohammad Najjar, interior minister and former defense minister¹⁰⁰
 - Majid Namjoo, minister of power¹⁰¹
- Members of Parliament
 - Arsalan Fathi, member of Parliament from Kaleybar and Horand (East Azerbaijan province)¹⁰²
 - Iyas Naderan, member of Parliament from Tehran and Majlis economic committee member¹⁰³
 - Mehdi Sana'i, member of Parliament from Nahavand (Hamadan province) and Majlis national security and foreign policy committee member¹⁰⁴
 - Mohammad Karim Shahrzad, member of Parliament from Esfahan (Esfahan province) and Majlis budget committee member¹⁰⁵
 - Hamid Reza Fuladgar, member of Parliament from Esfahan (Esfahan province)¹⁰⁶
- Others
 - Hassan Feroozabadi, chief of IRGC General Staff¹⁰⁷
 - Ali Naqib, chairman of the Association of Laundry, Hygiene and Cosmetics Industries¹⁰⁸
 - Hojjat al-Eslam Kazem Sedighi, temporary Tehran Friday Prayers Leader¹⁰⁹
 - Hamid Reza Tarraqi, member of the management council and cultural deputy at the Imam Khomeini Relief Committee¹¹⁰

Critics (varying degrees of opposition)

- Reformist Leaders
 - Mir-Hossein Mousavi, former presidential candidate¹¹¹
 - Mohsen Rezai, former presidential candidate¹¹²
- Members of Parliament
 - Qodratollah Alikhani, member of Parliament from Qazvin (Qazvin province)¹¹³
 - Asadollah Badamchian, member of Parliament from Tehran (Tehran province) and Islamic Coalition Party member¹¹⁴
 - Mohammad Reza-Bahonar, member of Parliament from Kerman (Kerman province) and deputy Parliament speaker¹¹⁵
 - Heshmatollah Falahat-Pisheh, member of Parliament from Eslamabad-e Gharb (Kermanshah province) and Majlis national security and foreign policy committee member¹¹⁶
 - Majlis Speaker Ali Larijani, member of Parliament from Qom (Qom province)¹¹⁷
 - Alireza Mahjub, member of Parliament from Tehran (Tehran province) and Secretary-General of Workers' House¹¹⁸

- Elyas Naderan, member of Parliament from Tehran (Tehran province)¹¹⁹
- Majid Nasipur, member of Parliament from Sarab (East Azerbaijan province) and Majlis social committee chairman¹²⁰
- Daryush Qanbari, member of Parliament from Ilam (Ilam province)¹²¹
- Shahriyar Taherpur, member of Parliament from Toyserkan (Hamadan province)¹²²
- Business leaders and economists
 - Jamshid Edalatian, economist and member of Iran's Chamber of Commerce¹²³
 - Behruz Sadeqi, industrial committee chairman of Iran's Chamber of Commerce¹²⁴
 - Ahmad Tavakkoli, head of the Majlis Research Center¹²⁵
 - Mousa Vafayan, head of Sari Chamber of Commerce (Mazandaran province)¹²⁶
 - Yuness Zhaleh, manufacturing, industry, and agriculture committee member of Iran's Chamber of Commerce¹²⁷
 - Kordestan business leaders¹²⁸

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