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Iran's Political, Demographic, and Economic Vulnerabilities

Keith Crane, Rollie Lal, Jeffrey Martini

Prepared for the United States Air Force

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Preface

This monograph is intended to help analysts and policymakers assess the political, demographic, and economic vulnerabilities of Iran to potential U.S. policy measures. The study dissects the political complexities and vulnerabilities of the Iranian government, evaluates ethnic and demographic tensions in Iran, and assesses recent economic developments and potential trajectories of future economic growth. It concludes with a set of policy recommendations for the U.S. government based on the analysis.

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Summary

After Iraq and Afghanistan, Iran is one of the most important U.S. policy concerns. The country appears to be on its way to becoming a nuclear power in the world's most volatile and violent region. Iran has been heavily involved in the Iraqi conflict, backing Shia political parties and training militias, and is the source of key components of the most lethal roadside bombs. Iran's current president has made highly inflammatory statements concerning the United States, Israel, and Western Europe. The country does not confine its provocations to rhetoric, providing weapons and financial support to Hizbullah, a group responsible for repeated attacks on Israel.

Purpose

The purpose of this monograph is to identify opportunities for U.S. policymakers to influence Iranian behavior along lines more favorable to U.S. interests and to evaluate potential domestic repercussions within Iran from potential military actions against the country. It also defines probable limits on the effectiveness of certain policies given current political, demographic, and economic conditions. It concludes by recommending and evaluating the likely effectiveness of potential U.S. policies that might exploit these vulnerabilities.

Political Vulnerabilities

Despite the theocratic basis of its state, Iran is one of the more democratic countries in the Middle East. The president and the Majlis (parliament) are elected; both men and women have the right to vote. However, Iranian democracy is severely constrained. Under the Islamic Republic and the system of *velayat-e-faqih* on which it is based, ultimate power lies with the religious authority, the Supreme Leader, Ayatollah Khameini. He controls the army and security forces and has the power to override any decision the elected government makes, including those of the president. The religious establishment vets all candidates for public office; those deemed insufficiently Islamic or insufficiently supportive of the regime are banned from running. (See pp. 10–13.)

Despite these authoritarian characteristics, most Iranians perceive the regime as legitimate. In the 2005 presidential elections, more than half of all eligible voters participated. Although many Iranians are dissatisfied with the authoritarianism of the regime, few have been willing or prepared to act outside the electoral process. The regime appears to be under no imminent danger of collapse or coup. Public questioning of the legitimacy of the current system has declined over the past few years in concert with government crackdowns on the media. Facing tough restrictions on the ability to meet and form political groups, those who democratically oppose the political system have been unable to organize effectively. Opponents of the regime who are willing to use force, such as the Mujahedin-e-Khalq, are largely discredited and in exile. (See pp. 20–34.)

Notwithstanding these realities, Iran's political system is not immutable. Iranians who push for change may become more willing to take risks as frustration grows or the sense that change is becoming possible takes root. Slow employment growth or declining incomes could increase the ranks and resentment of disaffected groups. If Iranians take to the streets, the government might have to deploy the Islamic Revolutionary Guard Corps and the Basij (a paramilitary force) to forcibly repress the opposition—a move the regime wishes to avoid, but one that would most likely effectively quash resistance.

Ethnic Vulnerabilities

Ethnic cleavages persist in Iran but do not provide an easy means of swaying Iran's leadership. Although Persians, the dominant group, account for only half the country's population, Iranian governments have been relatively successful in inculcating an Iranian identity into citizens from most other ethnic groups by emphasizing Shi'ism as a unifying force and fostering Iranian nationalism.

While the government has been largely effective in quelling major dissent, ethnic grievances, while muted, still generate political demands. Ethnic grievances focus on the use of language, distribution of government jobs, and equitable sharing of Iran's oil revenues. Non-Persian groups are often strong proponents of expanding civil liberties and the powers of elected government officials; they provided strong support to the reformist former president, Mohammad Khatami. These segments of the population are likely to play a significant role in moving the country toward a more-democratic system. (See pp. 37–56.)

Demographic Vulnerabilities

During the 1980s, Iran's population exploded, creating pressures for schools, new housing, and more public services for children. Rapid population growth is no longer a problem, in contrast to Iran's neighbor, Iraq, whose population continues to increase rapidly. Iran now has the lowest population growth rate in the region. As population growth has slowed, pressures on the government to provide health and educational services for children have abated, although much of the population still considers the levels and quality of services unsatisfactory. (See pp. 59–62.)

A more-pressing problem for the Iranian government is how to satisfy expectations for higher quality government services and lower-cost housing for Iranians living in urban areas. Iranians endure some of the highest urban housing costs relative to incomes in the world, making housing one of Iran's most pressing social problems. In urban

areas, dissatisfaction with the government is high because of widespread corruption and poor government services. (See pp. 62–65.)

Economic Vulnerabilities

Like other oil exporters, the Iranian regime has benefited from increased revenues as oil prices have risen since their nadir in 1998. Increases in oil output have also boosted exports and government revenues. Although nonoil sectors loom larger in gross domestic product, oil remains crucial for Iran's economic health, both as a source of budgetary revenue and exports.

Employment and incomes have risen sharply since 1998, but increasing oil prices have not been the only source of economic growth. Economic policy changes under the Khatami government accelerated economic growth over the last decade. The unification of the exchange rate and the relaxation of import barriers have contributed to increased output and employment in trade and manufacturing. But the Ahmadinejad government has been reluctant to continue these economic policies. Because Ahmadinejad is unlikely to continue to liberalize the economy, especially by reducing subsidies, Iranian growth may slow, and the government will face rising fiscal pressures.

The Iranian government also faces great pressure to generate employment for the children of the 1980s population boom. The number of young people entering the labor market has risen by four-fifths over the last two decades and is at an all-time high. The stultifying effects of regulation, government control, and the corruption of Iran's bureaucratic, state-run economic system have made Iranian youth highly cynical, even angry, about their prospects for employment.

Inflation remains stubbornly high, running in double digits. Failure to improve the effectiveness of monetary control will mean continued high rates of inflation, slower growth, and dissatisfaction with the regime.

Many Iranians believe the highly skewed distribution of wealth in Iran is due to corruption. Because the factors that foster corruption (price controls, state ownership of major companies and assets, compli-

cated regulations, lack of oversight of government contracting, etc.) are unlikely to change under Ahmadinejad, popular dissatisfaction with the current system is likely to grow.

Likely Domestic Consequences of U.S. Military Actions Against Iran

A number of commentators have discussed using military power to force the Iranian government to change policies that run contrary to U.S. interests, such as targeted attacks, responses to hostile action, or blockades. How effective would these actions be?

Attacking Iranian Nuclear Facilities

A large majority of Iranians strongly believe that Iran has the same right as other nations to develop nuclear energy, including the construction and operation of nuclear enrichment facilities. If Iran's facilities were to be bombed, public support for any retaliation its government took would likely be widespread. If Iran's nuclear facilities were to be bombed, richer Iranians would soon find means to transfer more of their wealth outside the country. Poorer Iranians would shift more of their assets from dinars to euros, gold, or dollars. Private domestic investment would take a hit. But at current oil prices, an attack would be unlikely to stop the Iranian nuclear program. The government would be able to finance the reconstruction of the facility and continue the current program without major budgetary consequences.

The ramifications of an attack for Iranian domestic politics are less clear. Ahmadinejad has come under fire from other politicians for baiting the United States. An attack might be perceived as his comeuppance. In our view, a more likely response would be a strong push to retaliate. Critics of such a policy would likely choose to keep silent.

Responding to Iranian Involvement in Iraq

Iranian society has been fairly insulated from the violence next door, although some of the hundreds of thousands of Iranian pilgrims to Najaf and Karbala have been targets of car bombs. Because so much of

the Iranian government's activities in Iraq are covert, these aspects of Iranian policies toward Iraq have not been subject to public debate.

If confined to Iraq, U.S. retaliatory measures against Iranian agents would be unlikely to elicit much response from the public. Substantial setbacks within Iraq might persuade the Iranian leadership to scale back its efforts. On the other hand, the intelligence services might just absorb their losses and continue to pursue their current activities. In contrast, attacks on Iran proper would generate a great deal of ill-will and, in our view, would be unlikely to change Iranian policy. The initial response of the current Iranian leadership would likely be to intensify covert activities against U.S. forces in Iraq and elsewhere.

Blockading Iranian Oil Exports

A blockade of Kharg Island, Iran's main oil loading terminal, or the Straits of Hormuz to prevent shipments of Iranian oil would effectively halt most Iranian exports. Maintaining a blockade for even a few months would have a devastating effect on the Iranian economy and living standards. Destruction of Kharg Island would hit the Iranian economy hard for a number of years.

A blockade, however, would probably do more to solidify public support for the regime than weaken it. During the Iran-Iraq war, living standards plummeted. Yet opposition to the war was muted because most Iranians rallied around the flag. Moreover, such a blockade would sharply increase world market oil prices, both because of the drop in the oil supply and because of concerns that the conflict would escalate. Iran would probably respond by attacking tanker traffic through the Persian Gulf. Depending on the circumstances, other producers in the region might refrain from increasing output in fear of or in solidarity with Iran. A sharp rise in the price of oil on the world market because of a massive disruption of oil exports from the Persian Gulf would probably push the world economy into recession.

Implications for U.S. Policy

At least in the near term, the Iranian regime is likely to be relatively stable and resistant to external pressures for dramatic change. But societal conditions for a more-constructive relationship with the United States exist: In contrast with the Arab Middle East, the United States is popular in Iran. Long-term trends suggest that Iran is likely to become more democratic and less obdurate.

U.S. policies vis-à-vis the Iranian government need to be designed with these conditions in mind. Although coercive strategies are possible and could achieve some specific policy goals, moving Iran toward a more generally cooperative stance will require a focus on encouraging tendencies and policies in Iranian society that favor the expansion of economic and personal freedoms. Broadly speaking, the U.S. government has opportunities to encourage Iranians, including members of ethnic groups, to push for expanded civil liberties and democratic practices in Iran. The United States also has the ability to encourage policy changes in Iran that would liberalize the economy, thereby possibly strengthening nongovernmental actors. Such an approach will not yield immediate fruit, and its ambitions will need to be modest. And as long as relations are so hostile, U.S. initiatives will require deft handling, perhaps more so than in the past.

Under these conditions, we argue that U.S. policy should focus on creating conditions for effective relations over the long haul. These policy options fall into three broad categories:

1. fostering conditions for a more-pluralistic, more-democratic political system by engaging with Iranian society
2. weakening the ability of the Iranian government to clamp down
3. penalizing the Iranian government or its officials for pursuing policies that harm the United States.

To foster conditions for a more pluralistic Iran, once the current crackdown in Iran moderates, the U.S. government should expand its public diplomatic policy by

- funding programs that facilitate contacts between Iranians and Americans more generously, especially those focusing on educational and other exchanges
- encouraging U.S. officials and private individuals to provide interviews and commentary for Iranian media and expand U.S.–supported radio broadcasts and other programs in local languages to provide unbiased information on and a forum for discussion of major social issues.

To weaken the ability of the Iranian government to clamp down on groups advocating increased pluralism, the U.S. government should

- mute U.S. policy statements advocating regime change; security forces often use these as an excuse for detaining individuals seeking more freedom
- discourage ethnic groups from revolting against the Iranian regime; Iranian security forces have convincingly shown that they can handle restive ethnic groups, and violent opposition to Iranian rule is more likely to entrench the current security and political forces than to elicit a positive change in regime policies
- support International Monetary Fund and World Bank efforts to encourage better economic management in Iran; this will help expand the sphere for private sector activity
- not oppose Iran's accession to the World Trade Organization.

None of these developments would threaten U.S. interests or reward Iran for behavior inimical to U.S. interests. However, in a number of instances, the Iranian government or its officials have pursued policies hostile to the United States. To discourage pursuit of these activities and to limit new sources of revenue for Iranian government coffers, the U.S. government should

- maintain the embargo on gas liquefaction and gas-to-liquids technologies, which is likely to prevent Iran from developing its natural gas resources for export; keep the embargo as a bargain-

ing chip until assured that Iranian policies have become more congruent with U.S. interests
- expand contingency plans to seize Iranian foreign accounts
- encourage U.S. allies to bar selected Iranian officials from obtaining visas.

The U.S. government is often accused of having a short attention span. But the United States has successfully pursued long-term policies, as in the containment of the Soviet Union, that have yielded considerable results. With Iran, the U.S. government will again need to keep an eye on the long term, communicating with the current government but also encouraging more discussion among Iranians and more contacts and interactions between Iranians and Americans. Societies and governments change. The U.S. government has some ability to foster favorable trends in Iran, but these policies will take time to come to fruition.

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Glossary

Ansar-e-Hizbullah	Helpers (or Followers) of the Party of God; a conservative Iranian militant group
Artesh	the regular army of the Islamic Republic of Iran
Assembly of Experts	an elected body of clerics that selects the Supreme Leader but whose members must be acceptable to the Guardian Council
ayatollah	a Shi'a Muslim legal scholar and religious leader; a title of respect for such a person. Certain higher-ranking individuals are described as *grand ayatollahs*
Basij	an Iranian paramilitary force
bazaari	merchant class
BBC	British Broadcasting Corporation
bonyad	religious charitable foundation
Bonyad-e-Mostazafan va Janbazan	Foundation of the Oppressed and Injured
CIA	Central Intelligence Agency
EIA	U.S. Energy Information Administration, part of the U.S. Department of Energy

Expediency Council	a group appointed by the Supreme Leader to break stalemates between the Majlis and the Guardian Council
fatwa	an Islamic legal pronouncement, made by a scholar considered capable of issuing judgments based on Sharia
flare	to burn off natural gas produced when oil is pumped from a well but not collected for use as a fuel in its own right
GDP	gross domestic product
Guardian Council	a group of jurists, half appointed by the Supreme Leader, half by the Majlis. The council evaluates the compatibility of parliamentary decisions with Islamic law and vets candidates for the Assembly of Experts, Majlis, and presidency
Hizbullah	Party of God
IMF	International Monetary Fund
IRGC	Islamic Revolutionary Guard Corps
JRM	Jame'e-e-Ruhaniyat e Mobarez [Militant Clergy Association]
Kargozaran	Hezb-e Kaargozaaraan-e Saazandegi [Executives of Construction Party]
KDPI	Kurdish Democratic Party of Iran
khums	literally, one-fifth (Arabic). The share of income that adherents of Shi'a Islam normally donate to clerics, as mandated by Allah

Majlis	Consultative Assembly; the Iranian parliament
maktab-khaneh	traditional religious schools
marja-e-taqlid	religious authority followed as source of emulation
mbd	million barrels per day
MEK	Mojahedin-e-Khalq [National Council of Resistance]
Mo'talefeh	Jami'at Mo'talefeh Eslami [Unified Islamic Associations]
moluk ot-tavayef	local chieftains
MRM	Majma-e-Ruhaniyun e Mobarez [Combatant Clerics Society]
NIOC	National Iranian Oil Company
OCHA	United Nations Office for the Coordination of Humanitarian Affairs
OPEC	Organization of the Petroleum Exporting Countries
PAF	Project AIR FORCE
peshmerga	armed Kurdish fighters
sharia	Islamic religious law
shura-ye foqaha	religious jurists' council
SNSC	Supreme National Security Council
Supreme Leader	the Iranian head of government. The post was first held by Ayatollah Ruhollah Khomenei
UAE	United Arab Emirates

ulema	religious leaders
UNDP	United Nations Development Programme
velayat-e-faqih	rule by the jurist; the principle by which a respected Islamic legal scholar heads the government of Iran, serving as the *vali-e-faqih* [Supreme Leader]
WTO	World Trade Organization

CHAPTER ONE

Introduction

The Problem

Iran's position among key U.S. policy concerns has ratcheted upward over the past few years. The country appears to be on its way to becoming a nuclear power in the world's most volatile and violent region. Iran has been heavily engaged in Iraq, providing political and financial support for Shi'a groups, including those that oppose the U.S. presence. Iran is the source of key components of explosively formed projectiles, a highly lethal type of roadside bomb that has killed large numbers of U.S. soldiers in Iraq. Iran's government has confronted the United States, Israel, and Western Europe over a broad range of other issues. It has not confined its divergent views to rhetoric. It provides cash and weapons to Hizbullah [Party of God] in Lebanon, and Hizbullah has used Iranian weapons to attack Israel. Iran also provides financial and political support to Hamas, the Palestinian party that rejects Israel's right to exist.

Since the fall of the shah in 1979, relations between Iran and the United States have been poor. The occupation of the U.S. embassy in Tehran seared into the minds of U.S. policymakers an image of Iran as a rogue regime with no regard for international law. Although the United States and Iran tentatively explored the possibility of warmer relations during the presidency of Mohammad Khatami, reports of continued Iranian support for terrorist groups and activities short-circuited U.S. interest in rapprochement. Since the election of Mahmoud Ahmadinejad to the presidency in 2005, Iran's relations with the West have deteriorated.

Iran plays a central role in the politics of the Middle East and is influential in the Muslim world. Although not an Arab state, Iran's leadership perceives the country as a regional leader in spearheading the Islamic Revolution and supporting Muslim ideals. Iran is a leading exporter of oil, with the third-largest reserves in the world. Iran's decisions about its foreign policy, becoming a nuclear power, oil and gas production, and religion ripple through the region and the world, rebounding on its neighbors and countries further afield.

Ahmadinejad's inflammatory statements about the Holocaust, Israel, the United States, and various western European states have made the United States and many western European states increasingly apprehensive about Iran's intentions and direction. Further, these statements have encouraged groups and individuals across the Muslim world to rally against the West. The possibility of an Iran with nuclear weapons has increased all these concerns and raised the possibility that Saudi Arabia and Turkey might pursue similar capabilities. Iran maintains military and security forces more powerful than those of its neighbors. In short, Iran poses a host of difficulties for U.S. policymakers.

Purpose

This monograph describes opportunities for U.S. policymakers to influence Iranian behavior along lines more favorable to U.S. interests and evaluates the potential domestic repercussions within Iran of potential military actions against the country. We first assess the Iranian leadership's vulnerabilities in its own political, ethnic, demographic, and economic environments. In examining each of these, we analyze the pressures on both government and society and identify where the United States may or may not be able to exert influence. We also describe how political, demographic, and economic conditions may limit the effectiveness of such U.S. policies. The monograph concludes by suggesting possible U.S. policies that could exploit these vulnerabilities within the constraints that the realities within Iran impose.

Organization

The next chapter assesses the political system and the political players in Iran, laying out the strengths and weaknesses of the government. We analyze how decisions on policies are made, the extent of popular participation in the political process, avenues for dissent, and the ability of government institutions to reconcile competing claims for power and resources. In Iran, parallel government institutions provide a number of avenues through which Iranians can register policy concerns. These institutions have spread policymaking authority across a broad range of actors. The chapter investigates how these unique facets of the Iranian political system exacerbate and temper Iran's political vulnerabilities.

Chapter Three investigates the role of religion and ethnicity in Iran as influences on both domestic and foreign policy. Iran is highly ethnically diverse, with Persians accounting for barely half the population. Historically, Iran's governments have perceived this ethnic diversity as a challenge to national unity. To counter ethnic cleavages, the current regime, like the shah before it, has sought to foster a sense of Iranian national identity to supplement, if not supplant, identities based on ethnicity. This and previous Iranian governments have drawn on Iran's overwhelmingly Shi'a makeup to create a strong religious source of national identity. These governments have had some success with these policies, but the larger minority groups still have the ability to significantly affect political developments and, at times, challenge regime policies.

Chapter Four evaluates changes in demographic pressures in Iran. On the one hand, birthrates have plummeted, easing pressures to build new schools and provide for a rising wave of children. On the other hand, the children born during the baby boom of the 1980s are now entering adulthood and looking for work. Through 2017, Iranian governments will continue to face great pressure to create more employment opportunities for this cohort.

In Chapter Five, we describe the major economic policy challenges the Iranian government will face through 2017. The Iranian government must effectively use this period of high oil prices on the world market and recent increases in Iran's oil output to accelerate growth in

incomes and employment opportunities. Simultaneously, the government needs to diversify sources of exports and tax revenues to become less reliant on the vagaries of the world oil market. We evaluate the degree to which Iran is dependent on oil and assess the extent to which it is likely to be able to allay this vulnerability.

The poor performance of Iran's economy has been a source of popular dissatisfaction. Since the 1979 Islamic Revolution, Iran's leaders have pursued highly distorting economic policies that have created an inflexible economy that has operated far below its potential. Under the Khatami government, economic policy changes accelerated the rate of economic growth, particularly in sectors other than energy, and the private sector grew more rapidly than the public sector. Under Ahmadinejad, these moves to liberalize the economy are likely to lag, if not retrogress. As large numbers of young Iranians enter the labor force looking for jobs (as described in Chapter Four), failure to reduce economic distortions, improve economic policy, and thereby accelerate growth will exacerbate economic dissatisfaction. We conclude Chapter Five by assessing the likely future course of the Iranian economy and potential increases in per capita incomes both under policies Ahmadinejad is likely to pursue and under a more-optimistic scenario in which the economic policy improvements Khatami began continue.

Chapter Six summarizes the key vulnerabilities the Iranian government faces and puts forward U.S. policies that could capitalize on these vulnerabilities. In addition to developing these recommendations, we discuss the likely limits of these policies to influence Iranian behavior.

Research Approach

We drew on a large body of ethnographic, political, and economic literature for this monograph. For the political section, we assessed official statements and drew on published studies and monitored the Web logs of Iranians to analyze the ongoing political discourse. For the demographic section, we drew on Iranian and Western studies and population projections for Iran from the U.S. Census Bureau. For the

section on economic developments and policies, we used primary data from the Central Bank of Iran and data on Iran from the International Monetary Fund (IMF). In all cases, we identified areas in which Iran faces problems, pressures, or other vulnerabilities and evaluated their depth. We then assessed the effectiveness of the measures the Iranian government has taken to mitigate these vulnerabilities.

CHAPTER TWO

Domestic Politics

Iran's political system remains a paradox in the Middle East. Iran is a country that has experienced an Islamic revolution, yet has institutionalized many democratic principles. Ultimate power remains in the hands of its clerical elite. The religious leadership controls the entry of all individuals into political positions, barring from political positions anyone who questions the legitimacy of the current system and the position of the Supreme Leader Ayatollah Khameini. Informal networks dominated by the clerical elite make decisions that circumvent the formal government bureaucracy.

At the same time, the citizens of Iran elect the members of the Majlis, the president, and other officials, including local governments. Citizens also elect the members of the Assembly of Experts, which selects the Supreme Leader. Elected government officials have the authority to make decisions on a broad range of issues, including the national budget. Elections are held peacefully and regularly; the candidate who wins the most votes takes office. Multiple candidates with differing ideological stances vie for seats, whether Majlis or presidential. The majority of citizens participate in the elections, signaling their support, however ambivalent, for the political system.

The Historical and Religious Basis of Iran's Political System

Iran's history has deeply influenced its approach to politics and foreign policy, and its past has instilled a deep distrust of foreign intervention.

The shahs of the 19th century ceded much of their economic power to the British and Russians. This led to the 1905 Constitutional Revolution, which was followed by a military coup in 1921, then a new royal dynasty in 1925 as Reza Shah Pahlavi took power.[1]

Shah Mohammed Reza succeeded his father in 1941. After the British-Russian occupation of Iran in World War II, he successfully regained control of the country, only to be challenged in 1953 by street protests. The National Front, with Prime Minister Mohammed Mossadeq at its head, set up a new government that restricted the shah's authority, leading him to flee the country. After Mossadeq's government nationalized Iran's oil industry, the United States and Britain intervened, reinstating the shah and forcing Mossadeq to resign.[2]

The 1953 restoration of the monarchy's power through outside pressure stoked lingering Iranian resentment of foreign interference. For many, the monarchy represented a history of corrupt secular elites determined, with the backing of foreign powers interested only in controlling Iran's wealth, to thwart any attempts by the people to control their own political future and democratize their political system. Continuing U.S. and British support for the shah's autocratic regime from 1953 until its end in 1979 produced a deep suspicion of Western intentions. Many Iranians consider the U.S. involvement in the return of the shah in 1953 justified the taking of U.S. hostages in 1979.[3]

The movement that overthrew the shah in 1979 was not united. The groups involved represented a wide range of ideological perspectives, including socialists, the Islamic left, democrats, and the Islamic right. As the dust settled after the Islamic Revolution, the most organized and militant of the groups, the Islamic right, was able to take the lead in forming the new government.[4] What began as a revolution against the corrupt regime of the shah provided an opening for the creation of an Islamic government under Ayatollah Ruhollah Kho-

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1 Ali Gheissari and Vali Nasr, *Democracy in Iran: History and the Quest for Liberty*, New York: Oxford University Press, 2006, pp. 25–30.

2 Robin Wright, *The Last Great Revolution*, New York: Random House, 2000, p. 11.

3 Interviews with visiting Iranian scholars in Washington D.C., 2004–2005.

4 Gheissari and Nasr, 2006, p. 84.

meini, in which the religious leader became the ultimate authority on issues ranging from religion, politics, and culture to foreign policy and defense. The new government institutionalized the role of the religious establishment in the state to ensure that the state complied with Islamic precepts. These new institutions worked in parallel with the state bureaucracy that had existed before the revolution, rather than replacing it. The decisions of the religious institutions, however, took precedence over those of the regular bureaucracy, undermining the authority of existing government institutions.[5]

The primary role of religion has had a powerful influence on both domestic and international policy decisions. The Islamic Revolution developed as a movement to strengthen the country against perceived threats emanating both from within the country and from abroad. Internally, the revolutionaries focused on uprooting corruption and the seemingly un-Islamic activities of the shah's regime, and on replacing the old system with a political and social system based on religious authority. Externally, the first years after the revolution were consumed by the export of the revolution, but this goal quickly became subsidiary to the Iran-Iraq war, which absorbed most of Iran's resources—military, economic, and human.

Shortly before the death of Khomeini in 1989, the Iranian religious establishment and government adopted a more-pragmatic set of policies. The tightly controlled economy had not delivered the increases in incomes and employment that the population had expected. Iranians chafed under the strict precepts of the Islamic Revolution. They found the administrative competence of the religious establishment wanting. However, the clerical elite was not willing to loosen its hold on the reins of government. Limited changes in foreign and economic policies were made under the guise of "pragmatism," while the religious establishment maintained its authority.

The election of Khatami in 1997 reflected popular support for political change. However, Khatami was unable to push changes past his conservative opponents in government during his eight years in

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[5] Moslem, Mehdi, *Factional Politics in Post-Khomeini Iran*, Syracuse, N.Y.: Syracuse University Press, 2002, p. 11.

office. Under the presidency of Mahmoud Ahmadinejad, political liberalization is even less likely than before.

Major Political Actors

The Supreme Leader

In Iran, authority lies in the hands of the Supreme Leader, a role established under *velayat-e-faqih* [rule by the jurist]. According to the constitution, the Supreme Leader has vast authority:

> the power to determine the general policies of the system of the Islamic Republic of Iran; supervise the effective performance of the regime's general policies; supreme command of the armed forces; declaring war or peace.[6]

The Supreme Leader also has the authority to appoint the Guardian Council and the head of the judiciary and control the state-owned media. He has final authority in the Iranian state.

This role was initially created explicitly for Ayatollah Khomeini, as leader of the 1979 Revolution and the ruling jurist. After Khomeini's death, Ayatollah Ali Khamenei inherited the title and authority of the position but not the influence and power. Khamenei lacks Khomeini's charisma and the religious credentials but has been able to keep the support of the conservative Assembly of Experts, which chooses the Supreme Leader. The assembly purposefully upgraded Khamenei's religious authority to enable him to become an ayatollah and issue *fatwas*. Unlike Khomeini, however, Khamenei has not become a Grand Ayatollah and is therefore not one of the highest religious authorities in Shi'ism.[7] As a result, Khamenei relies on the authority of other clerics to add weight when his credentials are lacking, while the clerics need

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[6] Moslem, 2002, p. 32.

[7] Wilfried Buchta, *Who Rules Iran?* Washington: D.C.: Washington Institute for Near East Policy, 2000, p. 53.

him to assert their influence.[8] The clerics in the Guardian Council and Assembly of Experts strongly support the system of *velayat-e-faqih*, as their own roles and powers depend on this system.

Assembly of Experts

The Assembly of Experts consists of 86 clerics responsible for selecting and, if necessary, replacing the Supreme Leader. The assembly has the authority to dismiss the leader, although it has yet to do so,[9] in addition to choosing a successor for one who has become incapacitated or has died. While the assembly is an elected body, with each province choosing a number of representatives according to its population for eight-year terms, the Guardian Council must vet all candidates. Ali Akbar Hashemi Rafsanjani was elected speaker of the Assembly of Experts in September 2007, decisively defeating a candidate backed by Ahmadinejad.[10]

Guardian Council

The Guardian Council consists of 12 jurists who evaluate the compatibility of the Majlis's decisions with Islamic law by comparing each law the Majlis passes against Islamic law and the constitution. At that point, the council may either ratify the law or send it back to the Majlis for amendment. The council also has the authority to determine who qualifies as a candidate for president or the Majlis. Council members serve six-year terms. The Supreme Leader appoints half the members, and the Majlis selects the other half on recommendations from the judiciary.[11] Ayatollah Ahmad Jannati currently heads the Guardian Council.

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[8] Ray Takeyh, *Hidden Iran: Paradox and Power in the Islamic Republic*, New York: Times Books, 2006, p. 33.

[9] Buchta, 2000, p. 66.

[10] "Rafsanjani to Lead Key Iran Body," BBC News, September 4, 2007.

[11] Buchta, 2000, p. 59.

Expediency Council

The Supreme Leader appoints all members of the Expediency Council. This council is responsible for breaking stalemates between the Majlis and the Guardian Council, advising the Supreme Leader, and proposing policy guidelines for the Islamic Republic. Ayatollah Khomeini established this body in 1988, a move that ultimately reduced the authority of the conservatives in the Guardian Council. The Expediency Council weakens the ability of the Guardian Council to reject laws passed by the Majlis at will.[12] The Supreme Leader further strengthened the Expediency Council in 2005, giving it supervisory powers over all branches of government. This effectively limited the powers of newly elected President Ahmadinejad by affording the Expediency Council and its leader, Rafsanjani, oversight over the presidency.[13]

The Judiciary

The judiciary is tasked with providing direction regarding the legal and religious basis for decisions. Judiciary decisions are not necessarily final: Influential clerics may challenge rulings as being un-Islamic and may issue different rulings.[14]

The President

The 1979 constitution established the positions of president and prime minister, dividing authority between the civilian heads of government. It put most decisionmaking powers in the hands of the prime minister. In 1989, Ayatollah Khomeini changed this system, eliminating the position of prime minister and transferring the prime minister's powers to the president. Today, the president has the authority to oversee the Planning and Budget Organization, the National Security Council, and the Supreme Council of the Islamic Cultural Revolution.[15] The

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[12] Moslem, 2002, p. 75.

[13] Karl Vick, "Iran Moves to Curb Hard-Liners," *Washington Post*, October 8, 2005.

[14] Moslem, 2002, p. 32.

[15] Buchta, 2000, p. 23.

president is elected by popular vote. However, the Supreme Leader must confirm his acceptability for the position. The president has no authority over the armed forces or security forces. Because the Islamic Revolution made the Supreme Leader the highest authority for all political, religious, and military issues, the president has never wielded paramount executive authority.

Majlis

Iranian citizens elect all members of the Majlis every four years. As with the presidency and other political positions, the candidates must be vetted by the Council of Guardians. In the last two elections, many reformist contenders for the Majlis were not permitted to run. In the Majlis elections of February 2004, the Guardian Council rejected approximately 2,500 candidates, including 87 sitting members of the Majlis. Banning so many candidates prompted popular protests; many members of the Majlis threatened to resign, but with no effect.[16] As a consequence, traditionalists have increasingly come to dominate the Majlis.

Military

The Islamic Revolutionary Guard Corps (IRGC) is the most politically important military force in Iran. It exists in parallel to the Artesh, the regular army. While the Artesh remains the critical military force, the IRGC has become an increasingly powerful political participant.[17] The IRGC was created in 1979 to defend the Islamic Revolution and to support Ayatollah Khomeini. During the Iran-Iraq War, the IRGC's role expanded as it became increasingly involved in the war. Today, the IRGC fields 150,000 soldiers and has air, land, and naval capabilities.

The IRGC has accumulated power and influence by placing senior officers in important political positions and by acquiring economic assets. In recent years, IRGC members have been elected to the Majlis; some have been appointed to key positions in the government. Mohammad Baqer Qalibaf, a former IRGC commander, ran

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[16] Kenneth M. Pollack, *The Persian Puzzle*, New York: Random House, 2005, p. 372.

[17] Takeyh, 2006, p. 34.

as a candidate in the 2005 presidential election.[18] These officers made large amounts of money in the 1990s because they were able to obtain permits to import previously embargoed goods, such as consumer electronics, Western clothing, and construction materials for resale on the domestic market.[19] The IRGC has aggressively pursued its commercial interests. In May 2004, it took over the new Imam Khomeini International Airport, rolling tanks onto the runway on opening day to block the operation of the airport by the Turkish consortium that had built it. The IRGC wanted its friends to run the airport instead. The IRGC claimed that Turkish participation in the airport venture threatened national security.[20] The IRGC has taken a strong stand on the nuclear issue. Major General Yahya Rahim Safavi, IRGC commander, has openly questioned why Iran should agree to conventions limiting its rights to own nuclear weapons.[21] The IRGC also exercises power through its influence over the Basij, a paramilitary organization, and over Ansar-e-Hizbullah, a radical vigilante group. The IRGC retains a central role in Iran as the defender of the political system of *velayat-e-faqih*.

The Supreme National Security Council

The president chairs the Supreme National Security Council (SNSC), a body comprising representatives of the IRGC, the Artesh, the Ministry of Internal Security, and other security agencies. This highly influential decisionmaking body is responsible for assessing threats to national security and setting defense and national security policies. The SNSC weighs in on critical foreign policy decisions and is involved in foreign diplomacy as well as nuclear negotiations. Hasan Rowhani, in his role as Secretary of the SNSC, was Iran's chief negotiator on nuclear issues with the European Union. He also visited Kuwait, Yemen, the United

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[18] Vali Nasr and Ali Gheissari, "Foxes in Iran's Henhouse," *New York Times*, December 13, 2004.

[19] Nasr and Gheissari, 2004.

[20] Gareth Smyth, "Iran-Risky Business," *Financial Times Business Limited*: *The Banker*, December 1, 2004.

[21] Takeyh, 2006, p. 157.

Arab Emirates (UAE), and Saudi Arabia in June 2005 to foster cooperation against terrorism and organized crime.[22] The Supreme Leader holds a seat on the SNSC and is critical to resolving internal policy debates among the various security agencies.[23] Ali Larijani replaced Rowhani as secretary in August 2005. He headed Iran's team negotiating nuclear issues with foreign states and organizations until October 2007.

Informal Decisionmaking

Policymaking is complex in Iran. Although formal institutions to execute decisions are firmly in place across the various spheres of the bureaucracy, the process of making a decision is far more complicated than an organization chart might suggest. In addition to the formal institutions—the office of the Supreme Leader, the president, the Majlis, the Guardian Council, Expediency Council, and the military—powerful informal networks exist. These informal networks may either buttress or displace the authority of their official counterparts. Individuals with strong revolutionary credentials and ties to the security apparatus, who often also hold official positions inside the bureaucracy, dominate these networks. These individuals are able to tap into independent sources of financing from the *bonyads* [religious charitable foundations] that receive *khums* [donations]. These networks influence decisions most where there are gaps or overlaps in government portfolios; in many cases, they serve as the final arbiters on an issue.

Ayatollah Ahmad Jannati, the head of the Guardian Council and a member of the Expediency Council, exemplifies the type of power that may be wielded through informal channels of authority. Jannati's authority and his ability to influence decisions far exceed the author-

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[22] "Presence of Foreign Forces in Region 'Source of Threat'—Iran Security Chief," Islamic Republic News Agency, *BBC Monitoring*, Web site, June 6, 2005.

[23] Daniel Byman, Shahram Chubin, Anoushiravan Ehteshami, and Jerrold D. Green, *Iran's Security Policy in the Post-Revolutionary Era*, Santa Monica, Calif.: RAND Corporation, MR-1320-OSD, 2001, p. 24.

ity stemming from his official positions. As a Friday prayer leader, Jannati has used his pulpit to argue against adhering to the Non-Proliferation Treaty and for the permissibility of suicide bombings as a means of resistance. He has also cultivated strong relationships with the IRGC and Ansar-e-Hizbullah.[24] Jannati is believed to have used the security forces to intimidate reformists and even carry out selective assassinations.[25]

Bonyads: Influential Power Brokers

Bonyads serve as another parallel instrument of power in Iran through their ability to redistribute income and dole out patronage. These foundations are estimated to control as much as 40 percent of Iran's nonoil economy.[26] The largest of these, the Foundation of the Oppressed, is estimated to have amassed $12 billion in assets and to employ 400,000 workers in its enterprises. The *bonyads* have officially prescribed duties, including providing for disabled war veterans, propagating Islam, and aiding the poor. They are also used to channel resources to regime allies and to help fund groups tasked with repressing regime opponents.

Although *bonyads* existed prior to 1979, they shifted their focus after the Islamic Revolution to managing the confiscated assets of the shah and his supporters. *Bonyads* are purportedly nonprofits and are therefore tax exempt. However, they control enterprises that dominate the manufacturing and industrial sectors and conduct much of Iran's commerce. *Bonyads* funnel their profits into various ideological, political, and personal causes. The Supreme Leader provides the only oversight for their activities. Not only are their financial accounts not publicly available, no numbers exist for the state funding or contributions they receive. The government also provides no information about its business and financial transactions with the *bonyads*.[27]

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[24] Buchta, 2000, p. 19.

[25] Buchta, 2000, pp. 162, 168.

[26] Wright, 2000, p. 278.

[27] Buchta, 2000, p. 73.

One of the largest *bonyads* is the Imam Reza Foundation, led since 1979 by Ayatollah Abbas Vaez-Tabazi. Wealthy and pious citizens have bequeathed their property to the foundation over the decades, so that the Imam Reza Foundation has accumulated approximately 90 percent of the arable land in the region of Mashad. The foundation owns other assets, including universities and a Coca-Cola bottling plant.[28] Ayatollah Vaez-Tabazi's influence runs much further than his corporate interests. He serves as a member of the Assembly of Experts and has ties to Ayatollah Khamenei through the marriage of their children.[29] Another *bonyad*, known as the Fifteenth of Khordad Foundation, offered a well-publicized $2 million bounty for the assassination of Salman Rushdie.[30]

The *bonyads* strangle access to credit through their political clout, receiving preferential lending treatment from the state-owned banks. Their status as religious and tax-exempt organizations provides them significant price and cost advantages over their non-*bonyad* competitors, which stifle competition. The profits and political influence the *bonyads* enjoy make economic reforms that would affect them difficult to implement.

The *bonyads'* powerful economic and political role in the Iranian political system serves to strengthen religious conservative forces. The foundations have entrenched interests in the continuation of the existing political system of clerical rule. Any serious attempts to reform the political system through the imposition of public oversight or economic liberalization would lead to severe financial losses for these foundations.

These powerful economic and political actors pursue their own interests, often at the expense of the state. Economic growth and employment may be critical issues for the government, but policy changes that foster growth are difficult to adopt if they hurt the inter-

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[28] Nicholas Birch, "In Iran, Cleric's Wealth Draws Ire," *Christian Science Monitor*, August 20, 2003.

[29] Buchta, 2000, p. 76.

[30] Human Rights Watch, "Iran," *World Report 1993*, Chicago, 1993.

ests of the *bonyads* and other powerful political actors.[31] The primary objective of these actors is to ensure that the regime protects their interests. The *bonyads* tended to support Ahmadinejad in the presidential election because his agenda was in many ways the most favorable to the status quo. Ahmadinejad campaigned for a return to the ethos of the 1979 Revolution and an even greater role for Islam in social and political affairs and against liberalizing the political system or the economy. Although he promised to rout out corrupt clerics, he has found this difficult in the face of opposition from the *bonyads* and the powerful clerics who control these vast economic interests. These clerics are unlikely to support an attack on their colleagues, and without their support, policy changes that would reduce corruption are unlikely.

Security Interests

Iran's security and military forces play a role in decisionmaking both through their institutional roles within the government and through their representation in informal networks. While defense against attack from a hostile power remains the state's most important national security concern, the primary activity of the IRGC and militias is to maintain internal control. The IRGC serves the office of the Supreme Leader and the Islamic Revolution. Its primary mission is to protect the Supreme Leader and the system of *velayat-e-faqih* against external and internal enemies. This mission is more important than protecting the territorial integrity of Iran. During a crisis, these forces may be deployed internally for as long as the Supreme Leader deems necessary. In contrast, the missions of the Artesh are far more like those of a traditional army. The roles of these two services overlap considerably. Both maintain parallel capabilities and, increasingly, train and exercise together. Their mandates to defend the Islamic Revolution and defend the country overlap as well.[32]

The IRGC and Artesh formally influence decisionmaking through their presence on the SNSC, participation in discussions with the president, and through the Majlis. Both organizations exert addi-

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[31] Takeyh, 2006, p. 38.

[32] Byman et al., 2001, p. 26.

tional influence through informal networks and the personal influence of their leaders. The IRGC has closer ties to the office of the Supreme Leader than does the Artesh and, therefore, probably has influence over a broader spectrum of issues. Ideological ties between the IRGC and conservative clerics and the Basij increase the IRGC's ability to press its views on various issues. IRGC's commander, General Safavi, issues statements on foreign policy and even domestic issues in prayers and speeches. In May 2005, Safavi stated that

> America's current policy is to create tension among Shi'as and Sunnis, but America must know the time when superpowers could dominate Islamic states has now passed and in this century all nations are aware.[33]

During the presidential elections of 2005, General Safavi encouraged people to vote, commanding the IRGC, members of the Basij, and others to "concentrate their efforts on maximizing the number of people who go to the ballot box."[34] After the election of Ahmadinejad, Safavi pointedly pledged the support of the IRGC and Basij to the new president. Safavi's public support of Ahmadinejad was in stark contrast to IRGC threats against former President Khatami's supporters in 2000, and reflected the conservative policy perspective of the security forces.[35] In contrast, commanding officers of the Artesh did not publicly encourage people to vote or issue statements regarding the new president, although the Artesh did offer congratulations to the new president after his election.[36]

Unofficial groups exist to support the goals of the Islamic Revolution. Ansar-e-Hizbullah is a conservative, religious, paramilitary orga-

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[33] "U.S. Aims to Create Tensions Among Shi'as, Sunnis-Iran's Commander," Voice of the Islamic Republic of Iran radio service, *BBC Monitoring*, Web site, May 20, 2005.

[34] "Guards C-in-C Says Negative Campaigning Against Candidates 'Religious Sin,'" Iranian Students News Agency, *BBC Monitoring*, Web site, June 20, 2005.

[35] Ali Akbar Dareini, "Iran's Hard Line Revolutionary Guards Pledge Support for Ultraconservative President-Elect," Associated Press, July 5, 2005.

[36] "Senior Iranian Military Officials Meet President-Elect Ahmadinejhad," Iranian Labour News Agency, *BBC Monitoring*, Web site, July 2, 2005.

nization that carries out attacks on individuals within Iran for perceived infractions against Islam. Typical targets include unmarried couples, protesters, and women with improper clothing or who are wearing cosmetics. A brigadier general of the IRGC, Hossein Allahkaram, leads the organization; many members of Ansar-e-Hizbullah are also part of the Basij militia.[37]

The group is deeply resented by many Iranians. In 1999, it was involved in an attack on students of Tehran University that killed two. In the aftermath, protests arose around the country against the methods of this organization.

Ansar-e-Hizbullah also takes a radical stance against the West and, in particular, the United States. The group has engaged in rallies to demand that Iran immediately pursue nuclear enrichment in response to Western attempts focused on getting Iran to abandon its enrichment program. The group's Web site has encouraged volunteers to register to conduct suicide attacks against the United States in case of a U.S. military strike against Iran.[38]

Iranian Factions

Even though Iran's political and religious decisions are firmly under the control of the Supreme Leader, the Iranian political and religious landscape is by no means uniform. It comprises many factions representing different parts of society and various ideological perspectives. The factions can be divided into three broad categories: (1) the reformers and the Islamic left; (2) the pragmatic right; and (3) the traditional right, also known as the conservatives (Table 2.1).

The Islamic left supports redistributive economic policies and strong state influence on the economy. In addition, this faction seeks to moderate clerical rule by empowering other institutions as checks

[37] "Iran's Suicide Bombers to Stage "Readiness" Manoeuvres," *Iran Focus*, September 5, 2005; "Ansar-i Hizbullah: Followers of the Party of God," GlobalSecurity.com, undated.

[38] "Enlist for Martyrdom by Internet, Says Hezbollah," Iranreporter.com, February 24, 2002.

Table 2.1
Factions of the Iranian Political Landscape

Faction	Policy Positions	Leadership	Base of Support
Reformers and Islamic left	Seek to moderate clerical rule by strengthening civil institutions. More liberal on social policies. Inclusive stance towards ethnic and religious minorities. Islamic left favors redistributive economic policies.	Mohammad Khatami Mehdi Karrubi Mustafa Mo'in	Intellectuals Youth Minority groups Women
Pragmatic right	Prefers more technocratic leadership. Predominantly Persian focus. Supports market-oriented economic reform, including foreign investment.	Ali Rafsanjani	Government functionaries Middle class
Traditional right, conservatives	Highly protective of *velayet-e-faqih*. Consolidation of Revolution at home is its highest aim. Suspicious of Sunni ethnic groups. Protectionist, populist economic policies.	Mahmoud Ahmadinejad Ali Khamenei Ali Akbar Nateq Nuri	*Bazaaris* Security apparatus

on the authority of the *ulema* [religious leaders]. Islamic leftists tend to support policies that favor the ethnic and religious minorities. The reformers are similar to the leftists but do not always support redistributive economic policies and are more market oriented. The reform movement emphasizes the need to democratize Iran and empower the people vis-à-vis the government. The reformers are also liberal with regard to social and religious policies.

The pragmatic right comprises technocrats and those who support market-oriented economic reforms and a smaller role for government in the economy. This faction also supports Iran's integration into the global economy and more-moderate foreign policy and relatively liberal sociopolitical policies.

The traditional right is protective of the institution of *velayat-e-faqih* and views the consolidation of the Islamic Revolution at home as its highest aim. This faction holds very conservative views on social and cultural issues. Politically, the traditional right is the least democratic of Iran's factions. It has created an implicit social bargain in its own favor: "In a sense, the hard-liners are offering the populace their own social compact, whereby in exchange for spiritual salvation, the public will relinquish the right to dissent."[39]

Each faction has the support of organizations of individuals with similar ideological persuasions. The most powerful of these is Jame'e-e-Ruhaniyat e Mobarez (JRM) [Militant Clergy Association], an organization of the traditional right. JRM is the strongest conservative religious and political organization in Iran; many of Iran's most senior leaders have risen through its ranks. Ayatollah Khamenei, Rafsanjani, and Akbar Nateq-Nuri have all been members.[40] Established in 1977, JRM played an important role in disseminating information about Ayatollah Khomeini to universities, mosques, and bazaars. Members organized and rallied support for Khomeini, promoting him as the head of the Islamic Revolution and as an alternative to the shah.[41]

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[39] Takeyh, 2006, p. 39.

[40] Khamenei resigned his membership on becoming the Supreme Leader but continues to have close ties to JRM.

[41] Moslem, 2002, p. 51.

JRM remains the center of the conservative groups, including the affiliated Society of Qom Seminary Teachers and the Jami'at Mo'talefeh Eslami [Unified Islamic Associations] (Mo'talefeh). These two organizations, in particular, significantly influence decisionmaking in Iran through their powerful members. Many of the most senior individuals in Iranian politics and the religious hierarchy belong to one of these groups. Ayatollah Ahmad Jannati is a prominent member of the Society of Qom Seminary Teachers, as are many members of the Guardian Council and all members of the Council of Experts.[42] Mo'talefeh represents the interests of the *bazaari* [merchant class] supporters of the Islamic Revolution, and the organization's members include wealthy conservative merchants. Mo'talefeh is led by Habibollah Asgar-Owladi, is well known for its radical revolutionary zeal, and is highly influential in the Revolutionary Guard. In 1964, Mo'talefeh assassinated Prime Minister Ali Mansur, whom they held responsible for the exile of Ayatollah Khomeini.[43] The *bazaaris* in Mo'talefeh support open-door economic policies that contribute to their financial interests but not economic measures that would increase competition from imports or other Iranian businesses.[44]

Because of differences on economic and social policies, then-President Rafsanjani engineered a split with the conservative right in 1996, establishing a new organization, Hezb-e Kaargozaaraan-e Saazandegi [Executives of Construction Party]. More commonly known as Kargozaran, this organization supports the pragmatic right with the stated purpose of promoting social justice, economic development, and the use of technical expertise to move Iran forward. Taking a pragmatic approach to development, the organization placed technocrats rather than ideologues in key positions. Kargozaran envisions a modern, internationally integrated economy for Iran. Success here would require substantial economic policy changes, including reducing barriers to imports, easing entrepreneurs' entry into new businesses, and privatiza-

[42] Moslem, 2002, p. 55.

[43] Moslem, 2002, p. 54.

[44] Farhad Khosrokhavar, "The New Conservatives Take a Turn," *Middle East Report*, 233, Winter 2004.

tion. The pragmatists believe that Iran should participate wholeheartedly in the global economy, borrow internationally, and allow partial foreign ownership of domestic industries.[45] This economic program is revolutionary because it attacks the *bazaari* conservatives and their interests.

In 1988, some members of the Islamic left, including Mohammad Khatami, split off from JRM to form Majma-e-Ruhaniyun e Mobarez (MRM) [Combatant Clerics Society]. MRM espouses more personal and economic freedom and implicitly opposes the degree of control the religious establishment exercises in the current system. Other organizations affiliated with MRM have similar ideological objectives but different memberships. The Organization of Mojahedin of the Islamic Revolution comprises nonclerics. In 1998, supporters of Khatami organized the Islamic Participation Party of Iran, a group that includes clerics, workers, Islamic women's activists, and other reformers.[46]

The Islamic left is revolutionary; it challenges the authority of the Supreme Leader and all the religious bodies. The Islamic left argues that the Supreme Leader derives his authority and legitimacy to rule from populist and democratic support rather than only from a religious mandate. This faction emphasizes the need for the Supreme Leader to be responsive to the people instead of being authoritarian. For this to occur, the left argues, the regime must be able to adapt its religious rulings to the modern, changing world.[47] In contrast to the conservative, traditional interpretation of the Supreme Leader's role, the Islamic left believes that the powers of the leader should be restricted by the wishes of the public.[48] The implication embedded in the Islamic left's vision for the country is that the governing and bureaucratic institutions should have more authority than the religious institutions.

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[45] Takeyh, 2006, p. 41.

[46] *Sazeman e mojahedin e enqelab e eslami* and *Hezb e mosharakat e Iran e eslami*, respectively (see Buchta, 2000, p. 13).

[47] Takeyh, 2006, p. 46.

[48] Moslem, 2002, p. 116.

Other Political Actors

Against *Velayat-e-Faqih*

The Iranian Freedom Movement, led by Mehdi Bazargan, originally supported the Islamic Revolution and the Supreme Leadership of Ayatollah Khomeini. After being appointed by Khomeini, Bazargan attempted to form a moderate, technocratic cabinet that could combine religious values with modernity.[49] He believed in the centrality of individual rights and stressed that Muslims should follow Islamic tenets of their own free will.[50] Bazargan's ideas were far more moderate than those of the revolutionary regime. After the takeover of the U.S. embassy in 1979, Bazargan and his cabinet resigned in protest.[51] Since then, the group has existed as the primary opposition to the regime and to the concept of *velayat-e-faqih*. Because of the Iranian Freedom Movement's opposition to the regime, none of its members are permitted to contest Majlis seats or the presidency; the group is not permitted to register as an official political party. Ibrahim Yazdi has led the group since Bazargan's death in 1995.[52]

Clerics

The clerics at the religious center of Qom pose a potentially powerful challenge to the authority of Ayatollah Khameini. However, their criticisms of Khameini's rule differ. Opposition clerics fall into one of three categories: clerics who believe that Khameini is unqualified to be the Supreme Leader, clerics who believe that *velayat-e-faqih* should be exercised through a council of leaders rather than one Supreme Leader, and clerics who oppose the system of *velayat-e-faqih* altogether.[53]

Many Qom-based clerics believe that Khamenei is religiously unqualified to hold the position of *velayat-e-faqih*. These clerics believe that the system of *velayat-e-faqih* is legitimate but argue that Khame-

[49] Takeyh, 2006, p. 97.

[50] Moslem, 2002, p. 97.

[51] Buchta, 2000, p. 80.

[52] Moslem, 2002, p. 97.

[53] Buchta, 2000, p. 88.

nei, unlike Ayatollah Khomeini, has not attained the level of *marja-e-taqlid* [source of emulation] and therefore is not qualified to serve as the Supreme Leader. This disdain for Khamenei's authority makes them one of the most serious challenges to the legitimacy of the regime. For Supreme Leader, many of these clerics favor Ali Montazeri, who was at one time a strong supporter of Ayatollah Khomeini and a likely successor. Montazeri was considered highly qualified for the position, but his criticism of the regime eventually led to his removal as successor and to his house arrest in Qom. He remains popular with reformers and the Islamic left for his support of greater separation between the religious establishment and the state, a moderate government, and the democratic election of the Supreme Leader.

Other clerics in Qom believe that the system of *velayat-e-faqih* has not been implemented properly. This group believes there should be no single jurist; instead, a council of clerics, called the *shura-ye foqaha* [religious jurists' council] should advise the state on Islamic issues. The council would include the highest-ranking clerics to collectively provide religious oversight of state decisions.

The third group of opposing clerics consider the system of *velayat-e-faqih* altogether illegitimate. These clerics argue that the concept of selecting a Supreme Leader is sacrilegious, as only the Twelfth Imam is the legitimate religious leader of the Shi'a. From this perspective, the *velayat-e-faqih* is an illegal construct that undermines the integrity of the religion and damages the authority of the clerics. Ayatollah Ali Sistani in Najaf in Iraq is the most prominent representative of this group of opposition clerics.

Mojahedin-e-Khalq

The Mojahedin-e-Khalq (MEK), also known as the National Council of Resistance, is a militant organization that aims to overthrow the Iranian government. The U.S. government and the European Union have designated MEK as a terrorist organization. Formed in the early 1960s, the MEK initially sought to topple the shah and attack his Western support network. During the 1970s, the MEK conducted terrorist attacks and assassinations against the shah's government and against

U.S. military personnel and civilians.[54] The MEK supported the 1979 takeover of the U.S. embassy and the taking of U.S. hostages but soon thereafter became a target of the clerics. Thousands of MEK supporters were killed, and the leaders of the group fled to Paris in 1981. During the Iran-Iraq war, the MEK received financial assistance from Saddam Hussein. After its expulsion from France in 1987, the group moved its headquarters to Iraq and proceeded to launch attacks against Iran from bases in Iraq, thereby drawing the ire of many Iranians.[55] The MEK also attacked Iranian embassies in 13 countries in the early 1990s. In addition to support from Saddam Hussein's Iraq, the organization has solicited donations from expatriate Iranians in Europe and the United States.

The MEK continues to conduct terrorist attacks against the Iranian regime but has suffered many setbacks because of the U.S. presence in Iraq. Whereas the Hussein regime harbored and provided financial support to the group, the new government in Iraq has not. Since July 2004, approximately 3,500 MEK members have been placed in Camp Ashraf in Iraq as "protected persons" under the 4th Geneva Convention, which protects noncombatants during armed conflict. Another 300 or so have returned to Iran after receiving assurances from the Iranian government that it would not retaliate against them.[56]

Although the MEK remains on the U.S. Department of State's list of terrorist organizations and although Human Rights Watch has criticized its members for extensive use of torture and other abuses, it has some supporters inside the U.S. government.[57] Because of the group's antiregime credentials, some U.S. officials believe the MEK may be

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[54] U.S. Department of State, "Background Information on Terrorist Organizations," Washington, D.C., 1999.

[55] Colin Robinson, "In the Spotlight: Mujaheddin-e-Khalq Organization (MEK or MKO)," Washington, D.C.: Center for Defense Intelligence, September 11, 2002.

[56] Jim Lobe, "Rights: An Iranian Rebel Group, Wooing U.S., Is Accused of Torture," Inter Press Service, May 19, 2005.

[57] David Leigh, "Tank Girl Army Accused of Torture: Guardian and Human Rights Watch Find Evidence of Abuse by Iranian Revolutionaries Under US Protection," *The Guardian* (London), May 31, 2005.

the key to destabilizing or overthrowing the Iranian government. The MEK leadership also argues that the group should no longer be classified as a terrorist organization; Maryam Rajavi, the coleader of MEK, has stated that the group is now committed to democracy and free elections. Charges former members have made against the group call Rajavi's statement into question. These individuals say that the group is a cultlike terrorist group, and if it came to power in Iran, Rajavi would set up a dictatorship.[58] Given the organization's history of terrorism and torture, if it were to come to power, it would be unlikely to support U.S. goals of promoting stability and democracy in the region.

Religious Intellectuals

Among Iran's religious intellectuals, Dr. Abdolkarim Sorush is one of the more influential. As a professor at Tehran University, Sorush initially supported the Islamic Revolution. He later changed his views, adopting the stance that religion must embrace rationality and scientific judgment.[59] In doing so, Sorush became a highly regarded, well-known philosopher. While accepting the permanence of the writings in the Qur'an, Sorush questions the Shi'a clerical interpretations of the Qur'an, challenging the elite's authority without openly opposing the rule of the Supreme Leader. He argues that Islam and democracy are compatible.[60] His lectures in Iran have often been interrupted by the conservative vigilante group Ansar-e-Hizbullah. Sorush's ideas are popular among students, religious intellectuals, and technocrats.[61]

Mohsen Kadivar is another of the more-influential reformist religious intellectuals in Iran. As a cleric, his scholarship stirs controversy because he argues against the system of *velayat-e-faqih*. Kadivar's writings assert that the system was constructed by clerics, not Allah, and is therefore subject to criticism.[62] Using Shiite theology, he argued

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[58] Leigh, 2005.

[59] Takeyh, 2006, p. 46.

[60] "Biography," *Abdolkarim Sorush Official Website* (English), October 29, 2007.

[61] Buchta, 2000, p. 84.

[62] Takeyh, 2006, p. 48.

that Muslims should be allowed to elect their leaders democratically.[63] Kadivar was imprisoned from 1999 to 2000 for his views but continues to be active in the reformist movement in Iran.

Iranian Political Participation and the Public

When Ali Mohammed Khatami ran for president in 1997, the voter turnout was 80 percent, reflecting deep, widespread public support for his more-democratic and socially liberal views.[64] Khatami's victory was viewed as a protest vote against the traditionalist right and a mandate for change and reform of the political system and for relaxation of strictures on individual freedoms.

By 2003, many Iranians viewed Khatami's presidency and its agenda to liberalize the political system as having failed.[65] Khatami had been swept into power with a mandate to reform a system perceived as corrupt and a revolution with crumbling legitimacy. Once elected, he had proceeded with caution, promoting incremental reforms rather than radical change. The Guardian Council and the judiciary successfully undermined Khatami's attempts at reform, and attacked and suppressed a number of his supporters among intellectuals and the media.[66] The conservative forces in the government were able to utilize the political system to bolster their agenda while undermining the forces of change. For example, in 2000, Khatami and his supporters attempted to expand the oversight the Majlis has of the various arms of the government that acted under the exclusive supervision of the Supreme Leader. The issue was referred to the Expediency Council for arbitration, which ruled that the Majlis was not allowed to investigate the performance of these organs. This, among other rulings, weakened

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[63] Scott Macleod and Nahid Siamdoust, "The Critical Cleric: Reclaiming Islam for a New World," *Time*, May 5, 2004.

[64] Buchta, 2000, p. 35.

[65] Ray Takeyh, "Iran at a Crossroads," *Middle East Journal*, Vol. 57, No. 1, Winter 2003, p. 42.

[66] Gheissari and Nasr, 2006, p. 138.

the reformist-dominated Majlis's ability to change the system.[67] By the end of Khatami's tenure, the conservative opposition had clearly overwhelmed his efforts. By the elections of 2005, the public had become disillusioned with his and the reformers' approach.

By the end of Khatami's second term, many voters were resigned to a conservative takeover of the presidency or, if a more reform-minded candidate were to win, the prospect of little change. Leading contenders for the June 2005 elections included former president Rafsanjani, a conservative pragmatist, and Ali Larijani, the former head of the Islamic Republic of Iran Broadcasting, a conservative and former chief negotiator for Iran concerning nuclear issues. Reformist Mehdi Karroubi was also considered a strong candidate.[68]

In the weeks and months prior to the election, Rafsanjani appeared to be the frontrunner, with reform candidates trailing by close margins. The election resulted in the surprise victory of Ahmadinejad, the former mayor of Tehran. Ahmadinejad's simple style and conservative image garnered enough votes to qualify for a runoff against Rafsanjani, in which Ahmadinejad won by 61.6 percent of the votes cast, in contrast to Rafsanjani's 35.9 percent. Ahmadinejad benefited from the contrast between his modest lifestyle and Rafsanjani's obvious wealth, commonly known to stem from corruption. Rafsanjani is extraordinarily corrupt, even for a state as corrupt as Iran.

Early speculations that the electorate would boycott the polls were incorrect. In the first round, turnout was estimated to be as high as 62 percent. Even if this was exaggerated by the leadership, the general consensus is that well over half the electorate participated in the first round, validating the results in the eyes of many Iranians. In the runoff, participation was officially reported to be 55 percent.

The elections, however, were tainted. Mehdi Karrubi suggested that the Supreme Leader's son, the Guardian Council, the IRGC, and Basij had paid or pressured some voters to vote in favor of Ahmadinejad.[69] Some analysts agree that Ahmadinejad might not have reached

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[67] "Expediency Council and Interests of the System," *Asr-e-Ma*, No. 157, April 12, 2000.

[68] "IRNA Conducts Poll on Iran Presidential Elections," *Payvand*, March 11, 2004.

[69] Gheissari and Nasr, 2006, p. 154.

the runoffs without illegal assistance, although they concede that Ahmadinejad conclusively won in the final round.[70]

Ahmadinejad's victory can be attributed to a variety of factors. Ahmadinejad drew on characteristics that appealed to voters. In the run-up to the elections, his campaign emphasized his simple lifestyle and conservative ideology.[71] He is not a mullah; public frustration with rule by mullahs made this a very positive characteristic. He comes from a working-class background, which appealed to lower-income Iranians, the bulk of the electorate, yet he has a doctorate in engineering. He served in the IRGC as a reserve colonel and is a self-proclaimed fundamentalist. He always wore a rumpled gray suit when photographed or filmed. His political advertisements contrasted his austere lifestyle with the extravagant lifestyles and wealth of Rafsanjani and his colleagues. Clearly, a significant bloc of voters related to Ahmadinejad's populist image and message and favored his focus on practical daily and economic issues.[72]

Democracy and human rights were noticeably absent from the campaign as rallying issues. Reformists had banked on the electorate demanding these political rights and were disappointed to find that the issues did not resonate as expected. The poor showing of reformists in the initial elections caused Rafsanjani to be cast as reformist in the runoffs against the more conservative Ahmadinejad, a portrayal that must have put off many supporters of reform.

To some extent, Ahmadinejad appears to be serving as the charismatic deputy to the noncharismatic Supreme Leader. Ayatollah Khamenei and his supporters control most of the levers of power within the government. Parliament has also exerted its authority, voting down a number of Ahmadinejad's nominations. However, the government now has more difficulty arguing that political divisions inside the government prevent Iran from complying with various issues of international concern. During President Khatami's tenure, the reformers were able to attribute their inability to complete reforms to conservatives.

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[70] Christopher de Bellaigue, "New Man in Iran," *New York Review*, August 11, 2005.

[71] Gheissari and Nasr, 2006, p. 156.

[72] Bellaigue, 2005.

Conversely, the conservatives had been able to point out the reformers' failure to move the country forward. Under Ahmadinejad, the conservatives are solely responsible for the successes or failures of their policies. An ineffective presidency could increase disaffection with the conservative faction and with the system as a whole.

Politics and Legitimacy in Iran

While the electoral turnout was fairly strong, the heavily vetted candidate pool in both Majlis and presidential elections undermined the legitimacy of the vote. The existence of informal networks also worked both to bolster and to undermine perceptions that policy changes can be made by democratic procedures. Elected officials are sometimes seen as powerless or controlled by vested interests because of the overarching role of the religious leadership in Iranian policymaking.

Divisions inside the government and across the electorate reflect two radically different views of the future of Iran. Conservatives strongly believe that the government must remain true to the Islamic Revolution and the primacy of *velayat-e-faqih* by maintaining religious authority in all political, social, and economic spheres. Reformers insist that, to be legitimate, the leadership must liberalize and more faithfully reflect public thinking. Many reformers support a strong role for Islam in the state but believe that diverse ideas and interpretations of Islamic precepts should be allowed. Reformers are also more likely to support government oversight of religious bodies and officials. This point of view is considered anathema by religious conservatives, who believe that religious bodies need no oversight save that of the Supreme Leader.

The conservatives are concerned about their own positions and influence in a reformed Iran. They believe reforms would ultimately undermine the revolutionary political regime.[73] To insulate their ideology and political positions from assault by reformers, the conservatives

[73] Hossein S. Seifzadeh, "The Landscape of Factional Politics and Its Future in Iran," *Middle East Journal*, Vol. 57, No. 1, Winter 2003, p. 65.

accuse the reformers of pushing the agenda of the West. By casting the discourse in terms of the West versus Islam instead of democracy versus authoritarianism, the clerical elite has been able to dominate the debate. The discussion has created pressure on reformers to prove that they are not in fact working for the United States or other Western countries. Fundamentalists have seized on U.S. statements to attack reformers as serving the interests of the United States.[74]

Official comments from U.S. and other foreign leaders concerning the political legitimacy of the Iranian government are listened to, disseminated, and discussed in Iran. They have influenced Iranian discussions of the political legitimacy of the regime. During Iran's 2005 election campaign, both the regime and voters took President George W. Bush's statements on the electoral process in Iran as a challenge. His statement purportedly increased voter turnout in reaction to critical remarks about the regime. The incident revealed the extent to which Iranians pay attention and respond to U.S. statements on internal matters in Iran. In this context, U.S. actions directed toward regime change in Iran are likely to backfire.[75] When facing criticism from the United States, which many Iranians view as complicit in the problems of the Iranian political system, Iranian citizens largely rally around the regime.

Although the Guardian Council had limited the candidates who ran in 2005, candidates with a variety of political views won in the first round. The top three vote-getters from the first round of the presidential elections—Rafsanjani, Ahmadinejad, and Karroubi—represented distinct colors in the political spectrum. In the second round, Iranian voters similarly viewed the two remaining candidates as being distinct choices.

Substantial participation in elections and an acceptance that the winner takes office give the Iranian system a legitimacy that more overtly authoritarian states lack. International speculation that popular discontent over regime legitimacy could lead to a systemic change in government in Iran needs to be tempered by the fairly broad-based

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[74] Takeyh, 2006, p. 219.

[75] Pollack, 2005, p. 423.

support for at least parts of the political system, as shown by widespread participation in voting, a voluntary activity.

The Political Outlook

The Iranian political system has shown an ability to weather dissent. The system is complex, with parallel structures for religious and bureaucratic authority. This complicated system provides both the strength to deflect opposition from within and the resilience to accommodate dissenting views. Elections and the accompanying debate protect the conservative leadership from serious internal threats by providing a release valve. The system engages the citizenry politically but in a controlled way. Citizens can turn to official channels for responses to most bureaucratic problems or other government-related frustrations in their daily lives. The existence of an elected president with a government bureaucracy beneath him buffers the office of the Supreme Leader from popular resentment and anger on many issues.

Facing strong restrictions on the ability to meet and form political groups, those who democratically oppose the political system are unable to organize. Opponents of the regime who are willing to use force, such as the MEK, have largely been discredited and are in exile.

Iran is passionately nationalistic. Although the citizenry may criticize the system, the clerics, and the president, the majority of Iranians feel they belong to one country, despite tensions over differences in ethnicity. Historical events in the national memory, including the cession of oil rights to the British and other interests and the coup against Mossadeq by the U.S. Central Intelligence Agency and the British, are significant factors that buttress this nationalism. In the face of foreign threats, Iranians of all political persuasions are likely to rally around the flag. Nationalism and a sense of past injury from the British and Americans have had a significant effect on the public's attitude toward nuclear issues. Iranians support their government's ability to make a

sovereign decision on the issue without regard to what faction or type of government is in power.[76]

Systemic change will require movement from within Iran. Support for reformers in future elections could lead to gradual change. A critical mass of people disillusioned with the system of religious authority could eventually cause a more-revolutionary change to the system. Past reactions of the Iranian public to external pressure on the government have made it clear that direct intervention by other countries in Iran's political future is not likely to receive strong indigenous support.

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[76] Author interviews of Iranian scholars, 2005; Web log entries on Iranian Web sites.

CHAPTER THREE

The Challenge of Ethnicity and Identity Politics

Iran's modern political history is replete with attempts to consolidate a single Iranian national identity that eclipses ethnic and tribal loyalties. In the Pahlavi era, this took place under the shah's modernization program, which extended the central government's administrative control to the periphery and promoted the Persian language and Persian culture to the exclusion of those of Iran's minority groups. The Islamic Revolution took a different tack but with a similar bent, emphasizing a religious identity that was by definition supranational and supraethnic but that, like the "Persianization" campaign of the Pahlavis, refused to recognize the heterogeneity within Iran. Simultaneously, especially during the Iran-Iraq war and the recent quarrels with the international community over Iran's nuclear program, the government has attempted to foster a common Iranian identity based on nationalism. The extent to which these ideologies have succeeded in consolidating an Iranian identity that supersedes ethnic loyalties remains an open question—and one crucial to understanding the likelihood that domestic political change or foreign intervention might take the lid off of these latent rivalries.

Unlike many of its neighbors, Iran has had a long history as a state—as Persia, the land has been an empire or state for millennia. Despite this long history, Iran has been a state for much longer than it has been a nation. This legacy has forced successive regimes to grapple with competing identities that do not necessarily correspond with Iran's geographic borders. The relatively well-integrated position of Iran's largest and most important non-Persian ethnic group—the

20-million-strong Azeri population—and the solidarity of nearly all segments of society in the defense of Iranian territory during the Iran-Iraq war (1980–1988) suggest that Iran has largely succeeded in forging an identity that surpasses longstanding ethnic and tribal cleavages. However, modern Iranian history suggests that some external interventions have sharpened ethnic cleavages within Iran.[1] Accordingly, the difficulty of managing identity politics in Iran deserves consideration both as a potential brake on political liberalization and as a threat to stability in the event of a power vacuum.

The Ethnic and Religious Composition of Iran

The Islamic Republic of Iran is ethnically diverse. Persians comprise only a little over half the country's population. The Azeris constitute another quarter. Gilaki and Mazandarani, Kurds, Arabs, Baluch, and Turkmen form significant minorities (Figure 3.1, Table 3.1). Ethnic and linguistic diversity in Iran is much greater than in Iran's western neighbors. For example, Iraq is about 60 percent Shi'a Arab, about 20 percent Sunni Arab, and a little less than 20 percent Kurd, with small populations of Turkomans and Assyrians.[2] Turkey is 80 percent Turkic. Perhaps the closest analogue to Iran in terms of ethnic diversity is Pakistan: The share of the largest group, the Punjabis, is similar to that of Persians in Iran; the remainder of the country consists of a large number of ethnic minorities. In contrast to the diversity of its ethnic landscape, Iran is relatively homogenous in terms of religion: 89 percent of the population is Shi'ite (Figure 3.2). What little religious diversity does exist is highly correlated with ethnicity: Iran's largest non-Shi'a bloc—Sunni Muslims—is largely drawn from Iran's Kurdish, Baluch, and Turkmen populations.

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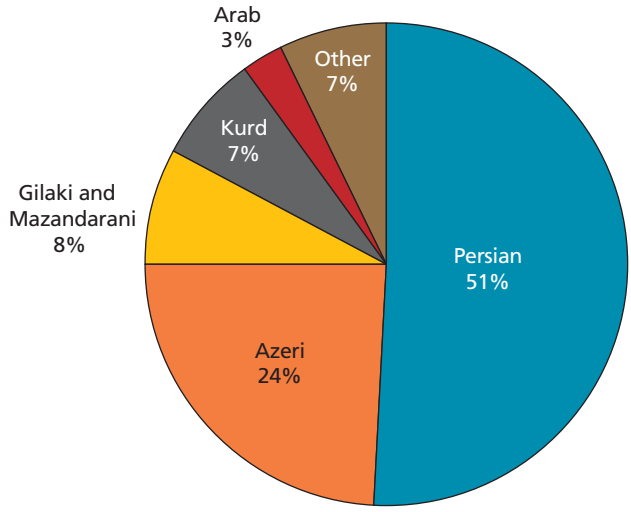
[1] External shocks include the Soviet occupation of northern Iran in World War II; the room that occupation created for Azeri and Kurdish provinces to agitate for local autonomy; and the establishment of the independent Republic of Azerbaijan in 1991, which strengthened ethnic loyalties among Iran's Azeri population across the border.

[2] Central Intelligence Agency (CIA), *The World Fact Book*, 2007.

Figure 3.1
Iran's Ethnic Composition



SOURCE: CIA, 2007.
NOTE: These figures are consistent with data from more-detailed studies of Iranian ethnography; see Brenda Shaffer, *Borders and Brethren: Iran and the Challenge of Azerbaijani Identity*, Cambridge, Mass.: MIT Press, 2002, pp. 221–225.

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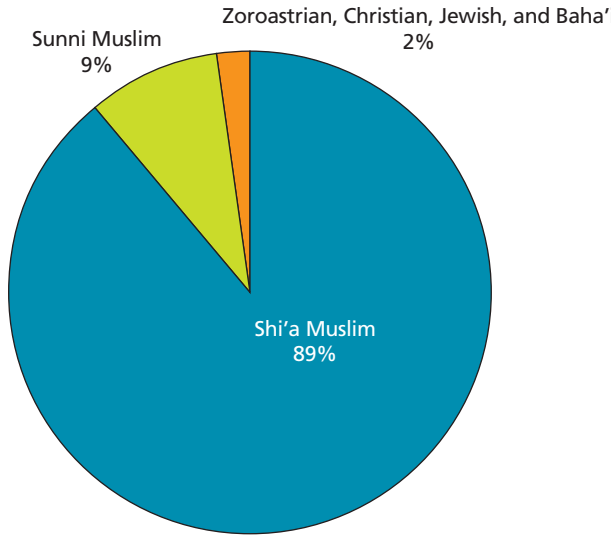
In the past, overlapping identities within Iran have posed political challenges to the regimes. The country's Azeri and Kurdish populations have frequently agitated for more cultural freedom and a greater degree of local autonomy vis-à-vis Tehran. These two groups have a geographically consolidated critical mass. Moreover, large communities of coethnics live in neighboring states (Figures 3.3 and 3.4). The last shah, Mohammad Reza Pahlavi, his father, Reza Shah Pahlavi, and the current rulers of Iran have managed to thwart and mitigate the secessionist tendencies of these two groups. Currently, only a very few individuals from these two groups are actively seeking to secede from Iran.

Table 3.1
Attributes of Iran's Major Ethnic and Tribal Groups

Group and Provinces in Which it Predominates	Religious Affiliation	Language Family	Nearby States with Coethnics
Ethnic			
Persian Hamadan, Tehran, Markazi, Qom, Semnan, Esfahan, Fars, Bushehr, Yazd, Kerman, Khorasan, Chaharmahal va Bakhtiyari	Shi'a	Indo-European	Afghanistan Tajikistan Uzbekistan
Azeri West Azerbaijan, East Azerbaijan, Ardebil, Zanjan, Qazvin	Shi'a	Turkic	Republic of Azerbaijan Turkey Republic of Georgia
Gilaki and Mazandarani Mazandaran, Gilan	Shi'a	Indo-European	
Kurd West Azerbaijan, Kurdistan, Ilam, Kermanshah	~75% Sunni	Indo-European	Turkey Iraq Syria
Arab Khuzestan, Hormozgan	Pred. Shi'a	Semitic	Throughout the Near East and North Africa
Baluch Sistan va Baluchistan, Kerman	Sunni	Indo-European	Pakistan Afghanistan
Turkmen Khorasan, Mazandaran, Gulistan	Sunni	Turkic	Turkmenistan Afghanistan Iraq
Lur Lorestan, Ilam, Boyer Ahmed va Kohgiluyeh	Shi'a	Indo-European	
Tribal[a]			
Talysh Golestan	Shi'a	Indo-European	Republic of Azerbaijan
Qashqai Fars	Shi'a	Turkic	
Bakhtiyari Chaharmahal va Bakhtiyari, Khuzestan	Shi'a	Indo-European	

[a] There are more than 90 independent tribes in Iran.

Figure 3.2
Iran's Religious Composition



SOURCE: CIA, 2007.
NOTE: These figures are consistent with data from more-detailed studies of Iranian ethnography; see Shaffer, 2002, pp. 221–225.

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Past Iranian Ethnic Policies

Shi'ite Islam is an important glue that holds together an Iranian national identity. The Islamic Republic of Iran has based its legitimacy on a form of cultural hegemony, as well as Iranian nationalism, using the homogenizing influence of religion to override ethnic and tribal loyalties. Since the Islamic Revolution, the definition of being Iranian has been heavily based on a common faith (Shi'ism) in addition to a broader shared culture and shared history. This religiocentric formulation of the Iranian identity has had great utility for the regime when subnational loyalties challenge its authority. In such instances, the universality of Islam can be used to delegitimize demands stemming from local concerns, as when the state responded to the Kurdish uprisings of the early 1980s. Ayatollah Ruhollah Khomenei's violent reaction to the unrest was revealing, exposing the inherent tension in his assertion of

Figure 3.3
Geographic Breakdown of Iran's Ethnoreligious Diversity

SOURCE: University of Texas, Perry-Castañeda Library Map Collection, 2004.

RAND *MG693-3.3*

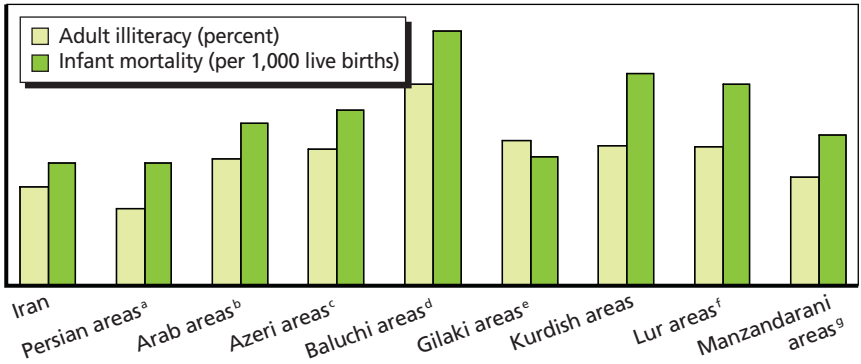
the universality of Islam and his espousal of minority rights. He stated at the time that, "[a]s far as Islam is concerned, there is no question of Kurds, Turks, Fars, Baluchi, Arab or Lor and Turkomen . . . . Everybody shall enjoy the protection of Islam"—even as the regime deployed the IRGC to put down the uprising.[3]

The emphasis on Shi'ism also serves to divide. Iran's Baha'is and Sunni Muslims have faced varying degrees of repression since the early years of the Islamic Revolution.[4] The Islamic Republic considers the

[3] Fred Halliday, "Iranian Foreign Policy Since 1979: Internationalism and Nationalism in the Islamic Revolution," in Juan Cole and Nikki Keddie, eds., *Sh'ism and Social Protest*, New Haven, Conn.: Yale University Press, 1986, p. 102.

[4] Under Article 13 of Iran's constitution, Zoroastrian, Jewish, and Christian believers are protected under law and are even accorded a small quota of seats in parliament. However, Baha'is suffer official discrimination, and Sunnis frequently complain of unfavorable treat-

Figure 3.4
Regional Disparities in Literacy and Infant Mortality



SOURCE: United Nations Development Programme (UNDP), *Human Development Report of the Islamic Republic of Iran*, 1999, pp. 61, 162, 167.
NOTE: The figures in the chart exclude provinces with significant ethnic diversity, such as Hamedan, Kerman, and Korasan.
[a]Bushehr, Chaharmahal va Bakhtiyari, Fars, Isfahan, Markazi, Qom, Semnan, Tehran, and Yazd.
[b]Khuzestan and Hormozgan.
[c]Ardebil, East Azerbaijan, West Azerbaijan, and Zanjan.
[d]Sistan and Baluchistan.
[e]Ilam, Kermanshah, and Kurdistan.
[f]Lorestan and Kohgilooye and Boyer-Ahmad.
[g]Manzandaran.
RAND *MG693-3.4*

Baha'is, members of a reformist offshoot of Shi'ism, to be heretics and have singled them out for particularly harsh treatment.[5] Even though the Baha'i community in Iran is tiny and poses no threat to the regime, the government executed some 200 Baha'is and jailed a further 600 in the 1980s simply for adhering to their faith.[6]

Sunni Muslims have not been subjected to the same degree of persecution as the Baha'is. However, Sunnis frequently suffer discrimination as both religious and ethnic minorities; much of Iran's Sunni

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ment. As one indicator of unofficial discrimination against Sunnis in Iran, there is not one Sunni mosque in all of Tehran.

[5] U.S. Department of State, *International Religious Freedom Report: Iran, 2004*, Washington, D.C.: U.S. Government Printing Office, 2004, p. 3.

[6] Juan Cole, *Sacred Space and Holy War: The Politics, Culture and History of Shi'ite Islam*, London: I.B. Tauris Publishers, 2002, p. 205.

population is of Kurd, Baluch, or Turkmen ethnicity. As Fred Halliday has argued, by

> denouncing the Kurds and Arabs as enemies of the nation, and evoking longstanding chauvinistic themes to justify its policies . . . . Islam itself, in its Shi'i interpretation, came to be used as a factor that compounded the nationalist divisions within the country.[7]

The reformist movement that former President Mohammad Khatami led took some of the edge off of the state's use of Islam as a tool for suppressing minority rights. Khatami made a concerted effort to reach out to non-Persian and non-Shi'a constituencies. Indeed, the support of these outsider groups was crucial to his two electoral victories. In the runup to the 1997 election, Khatami supporters distributed election materials in Kurdish and Azeri, and Khatami campaigned on a pledge to expand the language rights of Iran's non-Persian minorities.[8] This theme of inclusiveness and respect for differences featured prominently in the Majlis elections of 2000, when the reformist front adopted the slogan, "Iran for all Iranians."[9] In the more-recent elections of 2005 for the presidency and fall 2006 for the Assembly of Experts, more reformist candidates also campaigned on platforms of greater rights for ethnic groups.

The cleavages of identity politics in Iran have deep historical antecedents and are likely to remain a challenge to the Islamic Republic. When Reza Khan took power in 1925, a good part of Iran was effectively outside the reach of the central government, and what national political currents did exist (e.g., the 1905–1909 Constitutional Revolution) called for even greater devolution of authority to localities.[10] The

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7 Halliday, 1986, p. 94.

8 Shaffer, 2002, p. 219.

9 Farideh Farhi, "On the Reconfiguration of the Public Sphere and the Changing Political Landscape of Postrevolutionary Iran," in John Esposito and R. K. Ramazani, eds., *Iran at the Crossroads*, New York: Palgrave, 2001, p. 70.

10 Ervand Abrahamian, *The Iranian Mojahedin*, New Haven, Conn.: Yale University Press, 1989, pp. 11–41; Akhavi, Shahrough, "State Formation and Consolidation in Twentieth

shah's attempts to consolidate the Iranian state faced a series of hurdles, including linguistic differences; low levels of literacy; weak administrative control; and a large unsettled, rural population. Employing a combination of patronage and coercion, Reza Khan temporarily succeeded in displacing the authority of competing power centers—among them the clergy and tribal leaders. The shah's policies were authoritarian and often brutal, including the forced settlement of thousands of nomads, the compulsory unveiling of women, neglect or suppression of non-Persian minorities, and the concentration of power in Tehran.[11]

More benign, but equally calculating, was the creation of a system of mass education that would replace the *maktab-khaneh* [traditional religious schools] with state-sanctioned modern primary schools. These institutions became a crucial conduit for the shah to promote Persian as Iran's national language and thereby cultivate a unified national identity. The logic of this move was summarized in *Ayandeh*, a state organ whose first editorial proclaimed the following:

> Achieving national unity means that the Persian language must be established throughout the whole country, that regional differences in clothing, customs and such the like must disappear, and that *moluk ot-tavayef* (local chieftains) must be eliminated. Kurds Lors, Qashqa'is, Arabs, Turks, Turkmen, etc., shall not differ from one another by wearing different clothes or speaking a different language . . . . This task can only be accomplished if elementary schools are established everywhere, and if laws are passed which make education compulsory.[12]

During Reza Khan's reign, primary school enrollment increased more than fivefold, from 43,025 to 244,315 students. Significantly, all school textbooks were printed in Persian by the authorities in Tehran,

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Century Iran," in Ali Banuazizi and Myron Weiner, eds., *The State, Religion, and Ethnic Politics*, Syracuse, N.Y.: Syracuse University Press, 1986, p. 204. The Constitutional Movement was motivated in large part by a desire to institute municipal councils that were capable of representing localities vis-à-vis Tehran. See Touraj Atabaki, *Azerbaijan: Ethnicity and the Struggle for Power in Iran*, London: I.B. Tauris Publishers, 2000, pp. 27–39.

11 Cole, 2002, pp. 189–211.

12 Atabaki, 2000, pp. 56–57.

and the teaching of any other languages spoken in Iran was strictly prohibited.[13] Education became the key tool in the shah's efforts to merge Iran's national identity with that of its largest ethnic group, Persians.[14] The socializing influence of education was used to cultivate patriotism among Iran's youth, complementing the shah's introduction of mandatory military service as a second initiative designed to elevate allegiance to the nation over subnational loyalties.[15]

Another important facet of Reza Khan's consolidation of authority was the pursuit of investment and economic development in Iran's central Persian region; the periphery where the country's Azeri, Kurd, Arab, Baluch, and Turkmen populations resided was relatively neglected. Some of these areas—such as Baluchistan, which was a region of largely subsistence farming—had a legacy of underdevelopment prior to the shah's rule. Other areas, including the heavily Azeri provinces of East and West Azerbaijan, suffered from the shah's encouragement of industry in Tehran, Isfahan, and Mazandaran at the expense of non-Persian hubs like Tabriz. As an indicator of the shah's preferential treatment of the country's Persian center, the government invested in 20 factories in the country's Persian central and northern provinces during the last ten years of Reza Khan's rule but only two in the Azerbaijani region.[16]

This marginalization of the periphery continued under the rule of Mohammed Reza Shah (1941–1979). On the eve of the Islamic Revolution, the heavily Azeri, Kurd, and Baluch provinces trailed the Persian regions significantly in indicators of health, education, and income (Figure 3.4). In the Persian central provinces, 20 percent suffered from poverty, but more than 30 percent lived below the poverty level in Kurdish and Azeri areas and more than 70 percent in Baluchistan.[17]

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[13] Atabaki, 2000, p. 58.

[14] Shaffer, 2002, p. 48.

[15] Mostafa Vaziri, *Iran as Imagined Nation*, New York: Paragon House, 1993, pp. 192, 194–196.

[16] Atabaki, 2000, p. 60.

[17] Akbar Aghajanian, "Ethnic Inequality in Iran: An Overview," *International Journal of Middle East Studies*, Vol. 15, No. 2, May 1983, p. 218.

Similarly, while literacy rates in Persian areas stood at nearly 20 percent above the national average, the corresponding figures ranged from 5 percent to 18 percent below the mean in heavily minority provinces.[18]

This legacy persists today. The United Nations, for example, reports that the highest infant mortality rates and the lowest adult literacy rates within Iran are still to be found in Kurdistan and Baluchistan (Figure 3.4).[19] The same report points to "wide disparities" in development inside Iran that suggest the need for a "more equitable distribution of economic resources."[20]

On the surface, centralizing the shah's influence may have appeared to have been succeeding. However, the competing nationalities within Iran were dormant, only to reassert themselves when the Pahlavi regime was weakest. The most prominent example of agitation occurred at the end of World War II, when northern Iran was still under Soviet occupation, which insulated that part of the country from the regime's ability to enforce fealty. At that time, autonomous movements emerged among both the Azeri and Kurdish populations, culminating in the creation of the National Government of Azerbaijan and the Republic of Kurdistan on December 12, 1945, and January 22, 1946, respectively.

The new government of Azerbaijan stopped short of actually seceding from Iran, advocating a very loose form of federalism. While asserting that the Azerbaijani people constituted a distinct nation, the movement vowed not to challenge the territorial integrity of Iran. In return, the founders of this state-within-a-state demanded the use of Azerbaijani Turkish in local schools and government administration. They also voiced the desire for greater control over the allocation of local tax revenues and the establishment of provincial councils that would represent the Azerbaijanis in their dealings with Tehran, a right granted in the Iranian constitution but never recognized under the

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[18] Aghajanian, 1983, p. 216.

[19] UNDP, 1999, pp. 156–157.

[20] UNDP, 1999, p. 20.

shah.[21] The language issue proved the most popular platform among the movement's rank and file.[22] Despite enjoying broad support within their ethnic enclaves, the National Government of Azerbaijan and the Republic of Kurdistan were only able to survive as long as they enjoyed the de facto protection of the Soviet military presence. Just a year after their formation and seven months after the Soviet withdrawal, Tehran reasserted its control over the territories.

These autonomous movements remained largely in the background until they reappeared in the antimonarchy push that precipitated the 1979 Revolution. The Azeris, in particular, proved a crucial constituency in challenging the legitimacy of the shah's rule and eventually forcing his abdication. As in the case of the Azeris' activism under the Mohammad Mossadegh government in 1953, the community's goals were principally "all-Iranian" combined with some limited ethnic demands. From 1977 on, Tabriz University—and to a lesser extent the University of Rez'iyeh (Urmiya)—were a focal point of Iran's student protests and antiregime activism. On December 12, 1977—the date commemorating both the establishment and fall of the National Government of Azerbaijan—protestors at Tabriz University gathered to chant antiregime slogans. The protests led to a confrontation with military units that resulted in property damage and clashes that continued into the next day.[23] The pressure continued thereafter, with the Azeri population continuing to play an important role in the general unrest that forced the shah to abdicate.

Despite strong support and participation from ethnic minorities during the Islamic Revolution, as Ayatollah Khomeini consolidated his position in the aftermath of the Islamic Revolution, it became apparent that neither democracy nor minority rights were to be strong features of the Islamic Republic of Iran. After the revolutionary regime established power, ethnic groups once again attempted to carve out a measure of autonomy. Iran's Turkmen, Baluch, Arabs, and Kurds all staged revolts. With the exception of the Kurdish challenge, the regime put

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[21] Shaffer, 2002, p. 55.

[22] Atabaki, 2000, p. 105.

[23] Shaffer, 2002, p. 81.

each down relatively quickly (1979–1980).[24] The Azeri opposition was more circumspect, using boycotts of early votes—including the referendums on the establishment of the Islamic Republic of Iran (April 1979) and on the institution of *velayat-e-faqih* (December 1979), as well as the first presidential and Majlis elections—to challenge the legitimacy of the new leadership and protest the Islamic Republic's unwillingness to accommodate the demands of its non-Persian minorities.[25] Some of the more independent-minded within the Azeri community took to publishing in Azerbaijani Turkish—a freedom denied under Pahlavi rule—in an attempt to force the new leadership's hand in granting broader language rights. The government's response to such resistance was not violent but still coercive.

The proponents of merging political and religious authority, embodied in the doctrine of *velayat-e-faqih*, rejected the Azeris' ethnic-based demands and launched a counteroffensive that targeted Ayatollah Kazim Shariatmadari, an influential Azeri cleric and *marja-e-taqlid* who rejected theocratic rule and sought greater cultural freedoms. Ayatollah Shariatmadari was extremely popular in the Azerbaijani provinces; his confrontation with Khomeini was interpreted as symbolic of the broader struggle between ethnic minorities seeking some measure of autonomy in the new Iran and those who advocated a strong center and continued Persian dominance. In the end, Shariatmadari's support for local activists, opposition to *velayat-e-faqih,* and criticism of Khomeinei's prosecution of the war with Iraq after the Islamic Republic continued to press the offensive into Iraqi territory, led to Shariatmadari's defrocking.[26] Thereafter, the government gradually extended its control over the Azerbaijani provinces, using the war with Iraq as a pretext to wrap itself in the flag and appeal to the Azeris' sense of

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[24] Dilip Hiro, *Iran Under the Ayatollahs*, New York: Routledge, 1987, pp. 111–113; Patricia Higgins, "Minority-State Relations in Contemporary Iran," in Ali Banuazizi and Myron Weiner, eds., *The State, Religion, and Ethnic Politics*, Syracuse, N.Y.: Syracuse University Press, 1986, pp. 185–187.

[25] Shaffer, 2002, p. 79; Patricia Higgins cites 80 percent of the Azerbaijani electorate as boycotting the constitutional referendum; see Higgins, 1986, p. 189.

[26] Shaffer, 2002, pp. 90–103.

patriotism and the province's historic role as a bulwark against Arab expansionism.[27]

This government strategy—simultaneously placating the Azeris by stressing their important contributions to Iranian history and defense of the state, while making an example of any local activist who pushed too hard for greater local autonomy—continues today. Although no leader with the stature of Shariatmadari has since emerged as a spokesman for Azeri aspirations, the regime felt threatened enough to employ similar tactics in their efforts to sideline a popular candidate for the Majlis, Dr. Mohammad Chehregani, in the 1996 election and, again, in his second aborted election bid in 2000. An ethnic Azeri, Chehregani's 1996 campaign emphasized Azeri pride and his commitment to fight for cultural freedoms and economic development in non-Persian areas. Although Chehregani went on to win a large majority in the race, the candidate-elect was subsequently detained by state security and held until he agreed to resign. This state interference sparked large protests in Tabriz, at which many demonstrators were arrested. According to many press accounts but denied by Tehran, five protestors were executed and then hung from construction cranes as a warning against any further agitation.[28] For its part, Tehran contended that the timing of the executions was merely a coincidence—that the perpetrators were actually convicted of drug trafficking—although the circumstances and public display of the bodies would seem to indicate other motives.[29]

This discussion of Iran's minority groups is not intended to deny or underplay the existence of an "Iranian" identity. Rather, it points out that this Iranian identity exists concurrently with parallel and, at times, competing identities. These allegiances are neither mutually exclusive nor static. They have ebbed and flowed dramatically according to the orientation of the particular community, the policies of the regime in power, and external political developments. Accordingly, from the perspective of U.S. government policy toward Iran, policies focused on

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[27] Halliday, 1986, p. 106.

[28] Shaffer, 2002, p. 183.

[29] Shaffer, 2002, p. 183.

supporting non-Persian minorities need to be based on an objective assessment of the strength of these currents. U.S. policymakers need to determine which Iran the United States will likely face in the coming years: the highly nationalistic Iran of Mosaddeq and the early years of the Iran-Iraq War or the more-divided Iran that emerged at the tail end of World War II.

Present Challenges

Irredentism and Ethnonationalism

Although Iran's Kurdish population is only one-third the size of the Azeri community, the Kurds are the more-difficult problem from the perspective of the Iranian government. While the Azeris continue to raise the issue of state discrimination against non-Persians, they have proven more amenable to assimilation than Iran's Kurdish enclave.[30] As Shi'ites, the Azeri are also better integrated into the religious fabric on which the Islamic Republic of Iran's identity is predicated. Moreover, the sheer size of the Azeri community has forced the national government to be more accommodating. Azeris are well represented in the state bureaucracy, the government, and the religious establishment (Ayatollah Ali Khamenei is of Azeri descent). Heavy Azeri representation in Iran's *bazaari* class has provided the community with socioeconomic mobility and greater ties to Iran's Persian center.[31] Azeris' loyalty to the state in times of duress leaves them less vulnerable to the accusation of serving as a "fifth column"—a charge that has plagued Iran's Kurds since the Kurdish Democratic Party of Iran (KDPI) threw in its lot with Saddam Hussein during the Iran-Iraq war.[32]

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[30] Higgins, 1986, p. 188.

[31] Leonard Helfgott, "The Structural Foundations of Iran's National Minority Problem in Revolutionary Iran," *Iranian Studies*, Vol. XIII, Nos. 1–4, 1980, p. 206. Estimates of the Azeri population in Tehran range from one-third to one-half of the capital's total population; see Shaffer, 2002, p. 224.

[32] Nader Entasser, *Kurdish Ethnonationalism*, Boulder, Colo.: Lynne Rienner Publishers, 1992, p. 130.

The relationship between Iran's Kurdish community and the Iranian state is much more strained. Unlike the Azeris, the Kurdish aspirations for greater independence led them to support Iraq in the Iran-Iraq war.[33] At the outset of the Iraqi invasion, the Kurdish opposition movement initially expressed its willingness to come to an accommodation with the Iranian regime, offering the services of the *peshmerga* [fighters] in exchange for concessions from the state—among them Kurdish autonomy.[34] Tehran rejected this offer. Thereafter, the largest faction within the Iranian Kurdish resistance, the KDPI, began coordinating the Kurdish insurrection with Iraq's Ba'athist regime and other Iraqi-supported groups, such as the MEK, in exchange for military aid from Baghdad.[35] The legacy of this choice persists and feeds suspicions about the Kurds' ultimate loyalties.

After the Iranian government subdued the Kurds following the end of the war, violent uprisings persisted throughout the 1980s and early 1990s. The scale and brutality of the Iranian response to the revolt further alienated the Kurdish population from the Iranian government. Even after the conflict with Iraq ended, prominent KDPI leaders continued to be assassinated in Europe.[36] Following the first Gulf War, Iran took to bombing KDPI camps and sympathetic villages in the Iraqi no-fly zone.[37] Within Iranian territory, the Kurds were effectively put under military rule, with the Iranian government devoting an estimated 200,000 troops to securing the Kurdish provinces.[38]

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[33] Shaffer, 2002, p. 143.

[34] Farideh Koohi-Kamali, *The Political Development of the Kurds in Iran*, New York: Palgrave Macmillan, 2003, p. 190.

[35] Entasser, 1992, p. 130.

[36] In June 1989 and September 1992, KDPI leaders Abdul Rahman Ghassemlou and Mohammed Saddeq Sharfkandi were assassinated in Europe, presumably by the Iranian regime. A German special commission subsequently confirmed the Iranian government's involvement; see Koohi-Kamali, 2003, pp. 210–211.

[37] Nazila Ghanea-Hercock, *Ethnic and Religious Groups in the Islamic Republic of Iran*, New York: United Nations Commission on Human Rights, May 5, 2003, p. 8; Robert Olson, *The Kurdish Question and Turkish-Iranian Relations: From World War I to 1998*, Costa Mesa, Calif.: Mazda Publishers, 1998, p. 41.

[38] Koohi-Kamali, 2003, p. 212.

Iran's fears of separatist impulses have presumably been exacerbated by the U.S.-led removal of Saddam Hussein and the growing autonomy of Iraq's Kurdish regions. As far back as the Ottoman-Safavid rivalry of the 16th and 17th centuries, foreign powers have manipulated the Kurds as a wedge in the region. The superpowers had a similar strategy during the Cold War. More recently, Iran, Iraq, Turkey, and Syria have all played the "Kurdish card" as a foreign policy tool.[39] In light of this historical record, the Iranian regime is likely to continue to view the Kurdish population as a threat to internal security and a potential conduit of foreign influence. Iran's Minister of Intelligence and Security has pointedly warned against the "enemy's deceitful use of ethnicity as a tool in conspiracy."[40]

Iran is likely to maintain its heavy security presence in the Kurdish provinces and close control over the local population. The government's concerns about Kurdish separatist tendencies will continue to drive its policy. Security measures are likely to remain a drain on Iran's treasury.

However, Iran's Kurdish community has little potential to fight for autonomy. It lacks critical mass and remains split among factions within Iran and in relation to Kurdish groups in neighboring states. Although Kurdish nationalists often speak of a single Kurdish people, linguistic and cultural differences among the Kurds, as well as conflicting strategies over how best to secure the rights of their respective communities, have prevented the emergence of a cohesive national movement that transcends borders and unites all Kurds.[41] Iranian Kurds may remain a source of opposition to the Iranian regime but will not pose an existential challenge to the state.

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[39] Olson, 1998, p. 41.

[40] William Samii, "The Nation and Its Minorities: Ethnicity, Unity and State Policy in Iran," *Comparative Studies of South Asia, Africa and the Middle East*, Vol. XX, Nos. 1 and 2, 2000, p. 129.

[41] Abbas Vali, "The Kurds and Their 'Others': Fragmented Identity and Fragmented Politics," *Comparative Studies of South Asia, Africa and the Middle East*, Vol. XXI, No. 2, 2001, pp. 82–94.

Iran's Minorities and Political Reform

Iran's Azeri community is more likely to play a role in determining the future pace and direction of Iran's political evolution than in sparking an ethnically based separatist movement. Having proven its loyalty to the Iranian state and territorial integrity, most recently by resisting the attractions of the Republic of Azerbaijan, the Azeris are likely to work within the current system to address their grievances. Although the emergence of the independent Republic of Azerbaijan after the collapse of the former Soviet Union has been a source of Azeri ethnic pride, it has not generated popular support from the Iranian Azeri community to seek to join Azerbaijan or to strike out on its own.

The demands of Iran's Azeri community remain relatively modest, focusing on the expansion of cultural freedoms, such as local control over Azeri-language broadcasting, greater say in local government, and the promotion of the Azeri language at all levels of education, including university instruction. In light of the regime's need to avoid exacerbating dual loyalties inside its borders and the prominent role Azeris play in the government and the business community, the Iranian government is likely to offer carrots rather than sticks to its largest non-Persian minority.

Although some observers contend that Azeri nationalism could be exploited as a lever to influence the national government, there appears to be little popular support within Iran's Azeri community to assert a national identity other than Iranian.[42] The few organizations with such aims that do exist advocate solutions ranging from the creation of a federal Iran to the secession of "South Azerbaijan" and union with its northern neighbor. These groups are generally seen as organs of Baku rather than products of local activism. Prominent among these is the Southern Azerbaijan National Awakening Movement, an organization led by the former Majlis candidate Chehregani—now a dissident

[42] International Crisis Group, "Iran: Discontent and Disarray," Middle East Briefing No. 11, Brussels, October 15, 2003, p. 10; Afshin Molavi, "Iran's Azeri Question: What Does Iran's Largest Ethnic Minority Want?" EurasiaNet Commentary, April 15, 2003.

based in Washington, D.C.[43] These groups lack the domestic support to mount an effective challenge to the Iranian government. To the extent they are perceived as being connected to outside actors, such groups may undermine the credibility of local activists.

Iran's Azeri population has been a constituency of the internal reform movement. Historically, the Azeris have advocated a more-democratic Iran: during the Constitutional Revolution (1905–1909), in the Azeris' brief challenge to the shah in 1945–1946, and leading up to and immediately following the Islamic Revolution (1977–1980). Today, the center of Iran's Azeri community, Tabriz, is believed to "host the most active and progressive student democracy movement outside of Tehran."[44]

Iran's non-Persians may have a role to play in transforming Iran, but it will likely take place under the umbrella of a prodemocracy movement rather than through an ethnic-based opposition movement. The dual legacies of discrimination against ethnic minorities and the country's uneven economic development have created strong support in non-Persian areas for political reform. There appears to be a built-in protest vote in marginalized areas for challengers of all stripes. In both the 1997 and 2001 presidential elections, the non-Persian electorate tilted heavily toward the reformist, Khatami. Although Khatami's inability to effect change was a disappointment to many in these communities, their initial votes were widely interpreted not as being for Khatami per se but as being more generally in opposition to the status quo.[45]

Support for democratic political change among Iran's ethnic minorities is likely to persist so long as the country's periphery remains an economic backwater. Although the Iranian economy has been growing in the aggregate, the symptoms of underdevelopment remain acute in Iran's ethnic enclaves (Figure 3.4). Discrimination, compounded by

[43] William Beeman, "Rumblings in Azerbaijan—Bush's Hawks Eye Northern Iran," Pacific News Service, June 6, 2003.

[44] Molavi, 2003.

[45] Koohi-Kamali, 2003, pp. 214–215.

poorer economic conditions, could motivate ethnic groups to challenge the Iranian government in the future. As William Samii notes,

> [u]nder these circumstances, when people are dissatisfied with a major aspect of their lives, their dissatisfaction with other issues can take on added importance. So a Sunni Baluchi might find himself thinking that it is bad enough he cannot feed his family, but his family cannot even go to the mosque of its choosing. And a Kurd who is forced to move to a major city to find work will resent his children's inability to read Kurdish.[46]

Foreign Intervention and Iranian Nationalism

To what degree would the people of Iran stand united in the face of a foreign intervention? If confronted by a foreign power, could Iran's leaders count on popular support for the regime, or would a significant share of society see such action as a window of opportunity to break with the theocratic government?

On these questions, the U.S. experience in Iraq may be informative. However, any assessment should be prefaced by the understanding that identity politics in Iran differ markedly from ethnic politics in Iraq. Before the U.S. invasion, Iraq had been ruled by Sunni Arabs, a minority group, for its entire existence. In contrast, Iran is ruled by its largest ethnic group, the Persians. Unlike Saddam Hussein's Iraq, in which Shi'ites and Kurds suffered open persecution, ethnic and religious minorities in Iran are subject to subtler forms of discrimination and have more freedoms. Iraq is a fairly new state, cobbled together from some of the remnants of the Ottoman Empire. Persia has been a state for thousands of years.

The United States lacks natural allies in Iran. By contrast, in Iraq the Kurdish and Shi'a populations were predisposed to support overthrowing the Ba'athist regime. Although many, if not most, Iranians are unhappy with clerical rule, the depth of the grievances of Iranian minorities cannot be equated with those of Iraqi minorities.

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[46] Samii, 2000, p. 134.

On the other hand, while antipathy toward the United States is strong and growing in the Arab world, the United States enjoys much higher approval ratings in Iran, particularly among younger Iranians.[47] Conditions in Iran are in many ways the opposite of those that existed in Iraq, posing a very different challenge for the United States.

It is unlikely the United States could count on Iranian ethnic minorities to support a forced regime change. The sheer size of Iran, in terms of both territory and population, would make it much more challenging to convince potentially supportive populations that the United States could protect them from Iranian government reprisals. Unlike Iraq, where the United States could provide some security to Iraq's non-Sunni populations through no-fly zones, Iran's minority groups are much more exposed to the reach of the state.

Because Iranians are overwhelmingly Shi'ite and majority Persian, a regime change would be unlikely to change the political positions of ethnic groups or religious minorities. Although Iran's minority groups would prefer a more-tolerant regime, they do not have a realistic prospect of taking power. Contrast this with Iraqi Shi'ites, whose prospects helped spur the overthrow of Saddam and his Arab Sunni compatriots. Not surprisingly, Iran's ethnic groups appear to aspire to a more-modest range of objectives, with federalism standing at the far end of that continuum. Some groups might silently welcome foreign intervention but would be unlikely to make dependable allies for policies aimed at changing the regime by force.

[47] Patrick Clawson, "The Paradox of Anti-Americanism in Iran," *Middle East Review of International Affairs*, Vol. 8, No. 1, March, 2004.

CHAPTER FOUR

Demographic Change

Population and Rate of Growth

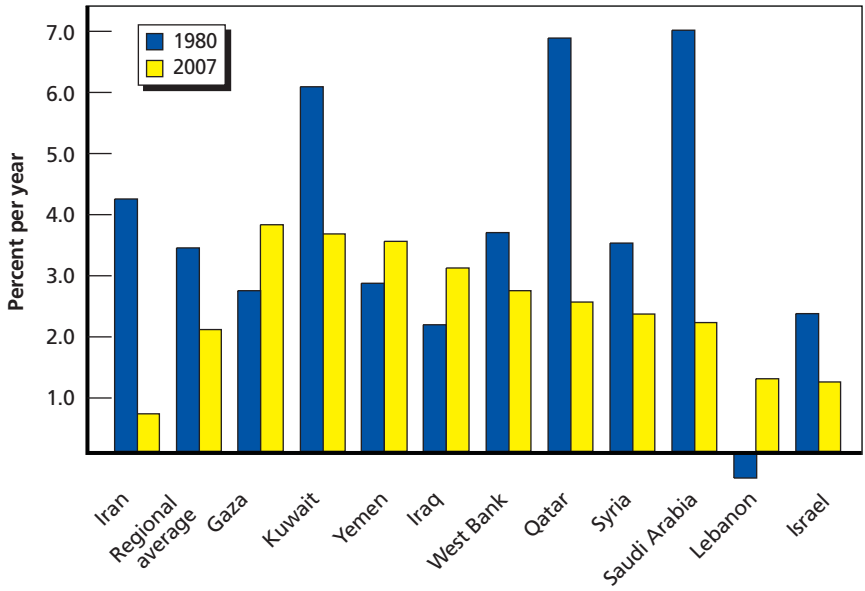
Although Iran is part of the Middle East, the sheer size of its population separates it from most other countries in the region. In 2007, the Middle East, excluding Iran and Turkey, was home to 128.8 million people.[1] Iran's population was 65.4 million, over one-half the total for the rest of the region. Iran's population is more than double those of Iraq or Saudi Arabia, its two largest Arab neighbors. The governments of both of these countries have found these population differences to be of concern for the regional balance of power.

But the rate of Iran's population growth has slowed dramatically since 1980. As Figure 4.1 shows, Iran now has the slowest rate of population growth among all the countries in the Middle East, including Lebanon and Israel.

This slow rate of population growth contrasts markedly with the situation in the early 1980s. In the immediate aftermath of the 1979 Revolution, fertility rates skyrocketed, running well over six children per woman of childbearing age. Population growth rates accelerated, pushing population growth from 2.9 percent per year in the early 1970s to over 4.4 percent in 1981, one of the most rapid rates of population growth in the world at that time.

[1] For the purposes of this monograph, we define the Middle East as consisting of Bahrain, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, the United Arab Emirates, Yemen, and the entities of the West Bank and Gaza. Population statistics are from September 9, 2007; U.S. Census Bureau, *International Database*, 2007.

Figure 4.1
Population Growth Rates in the Middle East



SOURCE: U.S. Census Bureau, *International Database,* 2007.

RAND *MG693-4.1*

The surge in fertility rates was driven partly by ideological and religious pressures and partly by public policies. In the immediate aftermath of the Islamic Revolution, the interpretation of Islam that the Iranian authorities, especially Ayatollah Ruhollah Khomeini, argued was that children are a gift from God and that contraception should be discouraged.[2] During the Iran-Iraq war, several political and religious leaders advocated increasing the population. The government provided economic incentives to encourage Iranians to have more children by adopting a rationing program for food and other consumer goods

[2] Daniel C. Maguire, *Sacred Choices: Right to Contraception and Abortion in Ten World Religions*, Minneapolis, Minn.: Augsburg Fortress Press, 2001. These authorities generally cite the Qur'an, surah 25, verse 74: "And those who pray, 'Our Lord! Grant unto us wives and offspring who will be the comfort of our eyes, and give us (the grace) to lead the righteous.'" (Abdullah Yusufali, tr., *Qur'an*, USC-MSA Compendium of Muslim Texts, Web site, Los Angeles: University of Southern California, tr. 1938 [7th c].)

based on family size.[3] For the first decade after the Islamic Revolution, the Iranian government did not have a family planning program.[4]

As Iran's population surged, the government reversed course. At the end of 1989, the government came out with a new policy that encouraged women to space their pregnancies, discouraged women under the age of 18 or over 35 from becoming pregnant, and encouraged families to limit themselves to two to three children. Iran's religious leaders approved this program and, after the death of Khomeini, issued *fatwas* stating that birth control is acceptable.[5] The change in religious and government views resulted in a reinstatement of government family planning measures. In 1991, a Department of Population and Family Planning was set up. These changes resulted in a sharp drop in fertility rates.

By 1999, fertility rates had plummeted to less than two children per woman of childbearing age, below replacement rates. By 2007, fertility rates were close to those in Western Europe, just 1.7 children per woman of childbearing age. In both urban and rural areas, preferences for number of children in a family have shifted from five or six to two or three children. By 2003, average family sizes in Iran had fallen to 4.6 people—5.0 in the countryside and 4.4 in urban areas—compared to seven or eight in Afghanistan or Pakistan.[6]

Although shifts in government policies and the attitudes of the religious leadership have contributed to the decline in population growth rates, the key change has been in popular attitudes toward the use of contraceptives and optimal family size. Iranians are much more likely to use contraceptives than men and women in the Persian Gulf states: 76 percent of Iranian women use contraceptives, and the religious establishment finds vasectomies acceptable as well.[7] Declines in

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[3] United Nations Office for the Coordination of Humanitarian Affairs (OCHA), "Iran: Focus on Family Planning," 2003.

[4] OCHA, 2003.

[5] OCHA, 2003.

[6] OCHA, 2003.

[7] OCHA, 2003.

child mortality rates have also contributed to lower fertility rates; parents now find it less important to have many children to ensure that some survive to provide for them in their old age. The rapid pace of urbanization has made children less of an economic benefit and more of an economic burden for parents, discouraging large families.

According to projections by the U.S. Census Bureau, fertility rates will remain at 1.7 children per woman over the course of the next decade, substantially below replacement rates. Despite this decline, Iran's population is projected to continue to rise for the next few decades as the large numbers of women born in the 1980s reach childbearing age. Although population growth is projected to rise to 1.0 percent per year through 2017 as these women begin to bear children, growth rates in nearby Arab countries are projected to remain much higher, running from 1.5 percent per year in Qatar to 3.4 percent in Yemen (Figure 4.2). The average for the Middle East is projected to run 2.1 percent.

Urbanization

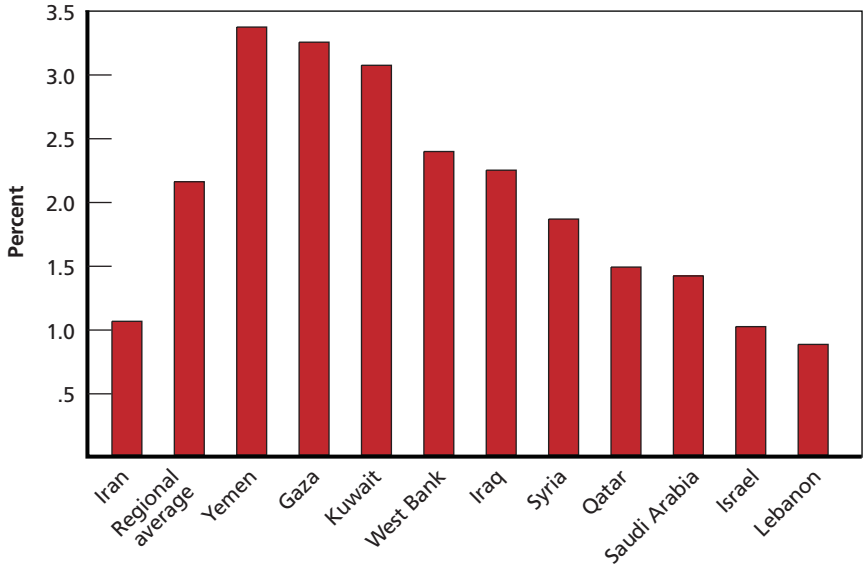
As in the rest of the Middle East, Iran has become predominantly urban. In 1970, only 42 percent of Iran's population lived in urban areas; by 2000, 62 percent of the population did so.[8] Urbanization is projected to continue.

Because Iran is such a large, ethnically diverse country, rural inhabitants do not simply head for the capital, as is common in more-centralized states. Most major Iranian cities have been growing rapidly—in some instances, even more rapidly than Tehran. Although Tehran attracts immigrants from all ethnic groups, many cities have an ethnic flavor. Tabriz is predominantly Azeri.

Single men and young families seeking to improve their economic lot comprise most of the immigrants. Although rural incomes have also

[8] Deniz Baharoglu, Nicolas Peltier, and Robert Buckley, "The Macroeconomic and Sectoral Performance of Housing Supply Policies in Selected MENA Countries: A Comparative Analysis," Washington, D.C.: The World Bank, April 2005, p. 4.

Figure 4.2
Projected Population Growth Rates in the Middle East in 2015



SOURCE: U.S. Census Bureau, 2007.
RAND *MG693-4.2*

risen, in part because growth in the rural labor supply has been tempered by migration to the cities, incomes are still substantially higher in urban areas.

Rural migration to urban areas and the resulting growth of cities have changed the complexion of Iranian society. As the last presidential elections show, poorer urban citizens, many of them with roots in the countryside, have a decidedly bitter view of the corruption in Iranian society and the wealth that corruption has given a number of politically prominent individuals. Urban inhabitants feel the quality of government services more immediately. Poorly functioning water, sewage, and transport systems affect urban dwellers every day, but people in the countryside have to rely on their own devices for water and sewage. Poorer residents of Tehran generally approved of Ahmadinejad's performance as mayor. His second-place finish in the first round of the

elections—and the opportunity it gave him to engage in a runoff election—were made possible largely by the votes of these immigrants.

Urban life has also changed the social mores and behavior of the immigrants as new arrivals are gradually inculcated with urban values and views. Iranian urban dwellers have smaller families, are better educated, and tend to be less religious than Iranians in the countryside.

Urbanization is putting financial pressure on the Iranian government. The rapid growth of second-tier cities, such as Mashad, Isfahan, and Shiraz, is precipitating demands for public investment in infrastructure; traditionally, Tehran has benefited disproportionately from such investment.

Urbanization has also exacerbated the economic and potential political costs of bad government policies. Urban Iranians are buying half a million motor vehicles a year, increasing consumption of subsidized gasoline, which in turn contributes to shortages and diverts oil production from exports to domestic consumption. Subsidized food prices, a major social benefit for urban dwellers, have distorted agriculture and the rural economy. The dominant role urban voters play in elections makes reducing these subsidies difficult.

The Iranian government and associations affiliated with the religious or governing establishment have pursued a number of policies that have dramatically increased the cost of living in urban areas. Because Iranian city governments own and control a large share of land in major urban areas (more than 30 percent), they determine much of the supply of housing through the retention or release of land for development. In many Iranian cities, local governments have allocated land to favored individuals or failed to release land for bureaucratic reasons. The slow pace of issuing construction permits has retarded development; Iran has an extraordinarily bureaucratic process for providing permits. As a consequence, relative to income, housing costs for Iranian urban dwellers are among the highest in the world: Average purchase costs run 10 times annual salaries.[9] High housing prices have encouraged immigrants to seek solutions outside the law: The share of informal housing (housing built by the poor who have no formal title

[9] Baharoglu, Peltier, and Buckley, 2005, p. 3.

to their houses, much less the land on which they stand) runs 30 percent of total housing in Iran.[10] High housing costs and the bureaucratic red tape associated with building housing have become potent political issues.

[10] Baharoglu, Peltier, and Buckley, 2005, p. 11.

CHAPTER FIVE

Economic Development and Vulnerabilities

This chapter examines Iran's current and likely future economic vulnerabilities, looking for economic pressure points the United States might use to attain its policy goals vis-à-vis Iran. We first assess the weaknesses and strengths of Iran's energy sector, evaluate its role in the Iranian economy, and consider how that role is likely to change between now and 2017. Next, we evaluate the strengths and weaknesses of the rest of the Iranian economy and assess the economy's major players, elucidating the roles of the state, *bonyads*, *bazaaris*, and other actors. Then, we evaluate the efficacy of Iran's recent economic policies. Following that is an evaluation of past and likely future changes in the Iranian labor force and the pressures the Iranian government is experiencing and will experience from the "youth bulge." We conclude by projecting Iran's potential economic growth through 2017.

Energy and the Iranian Economy

Reserves and Output of Oil and Natural Gas

Iran is in no danger of running out of either oil or natural gas. Over the last few years, estimates of oil reserves have been revised upward, from 89.7 billion barrels in 2002 to 136.27 billion barrels as of January 1, 2007.[1] Iran is now estimated to have 10.3 percent of global

[1] Estimates as of January 2007; see U.S. Energy Information Administration (EIA), "World Proved Reserves of Oil and Natural Gas, Most Recent Estimates," Washington, D.C., January 9, 2007.

reserves of oil, putting Iran in third place in the world, following Saudi Arabia and Canada (the Canadian figure includes tar sands). At current rates of production, Iran's oil reserves will last over 80 years, an eon in the oil industry. Iran is even better endowed with natural gas, with 15.8 percent of global reserves. Its natural gas reserves would last over a century at current levels of production.

Despite the size of its oil reserves, a number of commentators, including Iranians, have argued that Iran will not be able to sustain recent production levels.[2] Oil production peaked over 30 years ago under the shah, when it hit 6.0 million barrels per day (mbd), a level it has never regained (Figure 5.1). Output plummeted in the 1980s, a consequence of the Iran-Iraq war and lack of investment. A number of major fields had been depleted. However, oil production rose sharply between 1986 and 2005, more than doubling. Since 2005, oil output has fallen slightly as depletion rates of 8 to 10 percent in existing fields have not been totally offset by output from new fields or enhanced recovery techniques.[3]

Analysts have argued that the National Iranian Oil Company (NIOC) lacks the capital and technologies to develop new fields or to use more-sophisticated enhanced recovery techniques to sustain output.[4] These concerns have been reflected in some forecasts of Iran's ability to increase capacity and output. Under its base case forecast in 2006, EIA, part of the U.S. Department of Energy, projected that Iranian output will stagnate: The country will have capacity to pump only 3.8 mbd in 2010 and 4.0 mbd in 2015.[5]

Recent production figures suggest this forecast is too pessimistic. The Iranian government's own target of 5.0 mbd may even be attainable, although not by 2009, as the government had hoped. Output has

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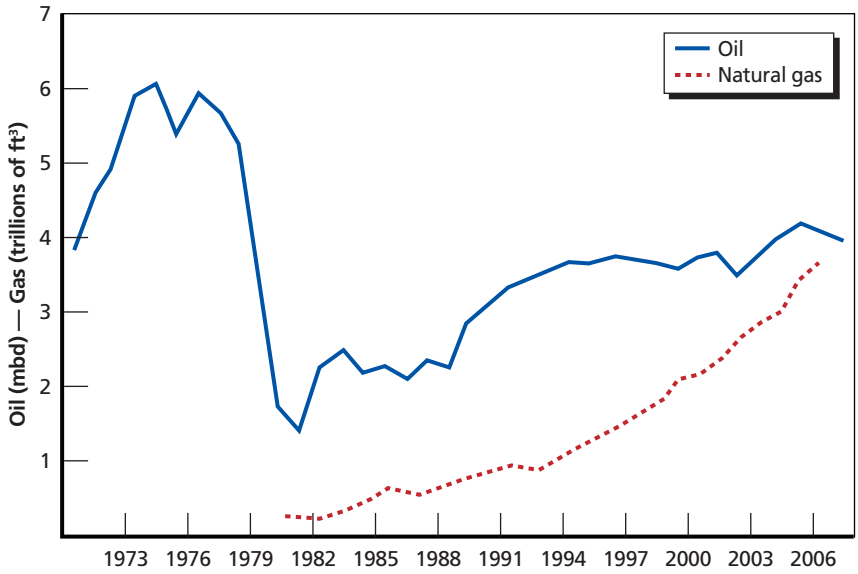
[2] Lionel Beehner, "Tehran's Oil Dysfunction," backgrounder, Council on Foreign Relations, February 16, 2007b.

[3] EIA, "Country Analysis Briefs: Iran," Washington, D.C.: U.S. Department of Energy, June 2006a.

[4] EIA, 2006a.

[5] EIA, *International Energy Outlook 2006*, Washington, D.C.: U.S. Department of Energy, 2006b, p. 155.

Figure 5.1
Iran's Oil and Gas Production



SOURCE: EIA, 2007.
RAND *MG693-5.1*

held up in recent years because of increases in production capacity, not to speeding up exploitation of existing fields. In July 2005, Iranian Oil Minister Bijan Namdar Zanghaneh stated that production capacity had been increased from 3.9 mbd to 4.2 mbd with the opening of the Darkhovein field in southwestern Iran and two offshore fields, Soroush and Norouz.[6]

Because so much Iranian oil comes from older fields, where production is declining, the operating costs of extracting it are higher than in most of the rest of the Persian Gulf. While the cost of extracting a barrel of oil in Saudi Arabia reportedly runs $2 to $3 a barrel, one of the lowest costs in the world, Iranian costs are more on the order of $15

[6] "Iran Oil Production to Reach 4.2m Barrels a Day," *IranMania*, London, July 24, 2005.

to $18 a barrel.[7] This cost differential is not just due to geology: NIOC is overmanned, and its payrolls are bloated, pushing up costs.

More important, the cost of developing new fields has been rising, as new discoveries have been offshore or involve more-difficult technologies. As a consequence, Iran has become more receptive to foreign involvement in its oil sector since 1997. Although the constitution prohibits foreign firms from taking equity stakes in oil production projects, such firms have become involved in developing new fields and increasing output from old fields through buy-back agreements that entail guaranteed prices and supply volumes. Deals with Japanese and Chinese companies provide financing for the development of new fields. Such companies as France's Total, Norway's Statoil, and foreign subsidiaries of Haliburton have been selling services to increase production.

The increased output is not due solely to foreign participation. High oil prices on the world market have generated revenues that have permitted the Iranian government and the NIOC to invest in new fields and to increase or maintain production from existing fields. Purchases of services from international oil service companies will continue to play an important role in exploring and developing new fields and in enhancing recovery from existing fields. However, knowledge and technologies diffuse more rapidly in the oil industry than in the past. Through study and training, Iranian oil engineers and managers are improving their operating procedures and exploration and production techniques, which has helped sustain production. Where Iran lacks the expertise or techniques inside the country, oil revenues have provided the resources to purchase missing technical and exploration services.

Iran has been rapidly expanding natural gas production. Output rose 15-fold between 1980 and 2006. Initially, natural gas was produced only in conjunction with oil and, before collection systems were built in the oil fields, was flared (burned off). Now, most associated gas is collected and consumed domestically or reinjected into the oil field

[7] Robert Windrem, "Are Saudis Waging an Oil-Price War on Iran?" MSNBC, January 26, 2007.

to enhance recovery. Since the early 1980s, gas has been produced in its own right, not just in conjunction with oil. Currently, 60 percent of the output is consumed within Iran, primarily for power generation but also as an industrial fuel. As consumption of refined oil products, especially gasoline and diesel, has risen, natural gas has played an important role in maintaining oil exports by replacing oil for uses other than in transportation. Another 30 percent of the natural gas produced is injected into oil fields to enhance recovery of petroleum. The last 10 percent is still flared from oil fields where it has been too difficult or too expensive to build collection systems.

The Iranian government sees natural gas as an important means of diversifying away from the country's current dependence on oil for export and government budget revenues. The government and NIOC have been investing heavily in developing new gas fields, the largest of which is the South Pars field in the Persian Gulf, Iran's largest current energy project.[8] The development of South Pars has shifted the focus of Iran's energy policy from oil to a balance between oil and gas. While oil output dictates the amount of associated gas output, the optimal rate of extraction from the gas field is what drives output from South Pars and other gas fields.

Iran currently exports less than 3 percent of the natural gas it produces.[9] Despite plans to change that state of affairs, progress is unlikely to be as rapid as the Iranian government hopes. Iran opened a pipeline to Turkey in January 2002 and began exporting, but because Turkey had signed a number of other deals with neighboring gas producers it has purchased less Iranian gas than expected. The two countries have had a number of disputes about prices and volumes. Iran hopes to export gas to Europe through Turkey, but another pipeline would need to be built to link Iran's current pipeline to Turkey and then to Greece. No construction contracts have been signed as yet. Iranian gas sales to Europe would have to compete with alternative supplies from

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[8] EIA, "Country Analysis Briefs: Persian Gulf Oil and Gas Exports Fact Sheet," Washington, D.C.: U.S. Department of Energy, September 2004.

[9] EIA, 2006a; IMF, "Islamic Republic of Iran: Statistical Appendix," IMF Country Report 04/307, Washington, D.C., September 2004a, p. 16.

Russia and Central Asia. European disappointment in Iranian nuclear policies makes a gas deal more difficult because any pipeline project would probably need the financial backing of official lending agencies of western European governments.

Iran is discussing pipeline projects to the east to supply India through Pakistan; Pakistan's demand is largely covered by its own production. But uneasy relations between India and Pakistan have made financing such a pipeline difficult. Although Iran and India signed a memorandum of understanding for such a pipeline in 1993 and another agreement in September 2005, the project has still not gotten off the ground.[10]

Iranian government officials are planning to construct two liquid natural gas trains in the Persian Gulf to liquefy gas from the South Pars field for export. These projects are not expected to come on line until 2010. Phase 14 of the South Pars development plan calls for the construction of a facility to transform natural gas directly to diesel fuel, but as long as Iran's relations with the West, especially the United States, remain strained, these expensive, technologically challenging gas-to-liquids projects are unlikely to come to fruition. Iran would need a major Western oil partner to provide the technological and management expertise. U.S. sanctions and opposition, the poor climate for foreign investment in Iran, and the difficulties foreign oil companies have had resolving contractual disputes with NIOC with current projects make it doubtful that any major oil company with technological expertise in gas-to-liquids would jump into Iran soon.

The Role of Energy in Gross Domestic Product, Exports, and the Budget

Energy is linked to Iran's economy by a variety of threads, accounting for a substantial share of economic output, supplying most of the country's exports, and being the most important contributor to the national budget.

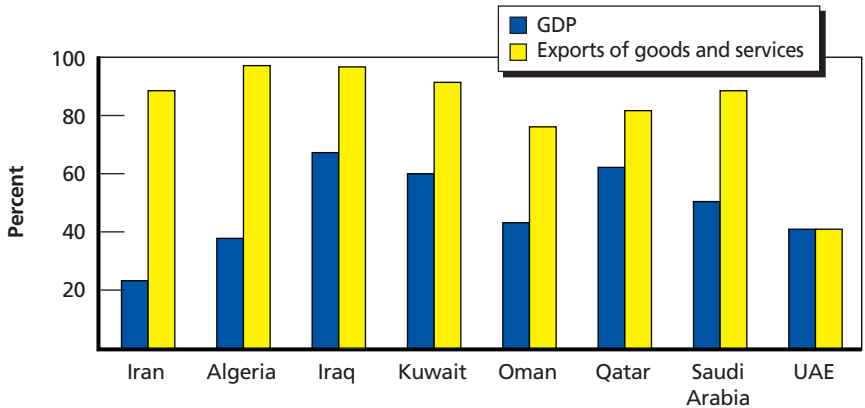
Although oil and gas are important components of gross domestic product (GDP), they comprise a smaller share than in the other Persian

[10] EIA, 2006a.

Gulf states: 23 percent, compared to 33 to 60 percent of GDP in the other countries (Figure 5.2). In Iran, agriculture, manufacturing, and other nonoil sectors are much more important to the economy than elsewhere in the region.

Despite oil's more-limited contribution to GDP in Iran than in other oil-exporting Middle Eastern states, oil has been an important driver of economic growth. A statistical analysis of the relationship between oil production and GDP indicates that a 10-percent change in oil production leads to a 2.7-percent change in Iran's GDP.[11] Figure 5.3

Figure 5.2
The Role of Energy in Iran and Energy-Rich Middle Eastern States



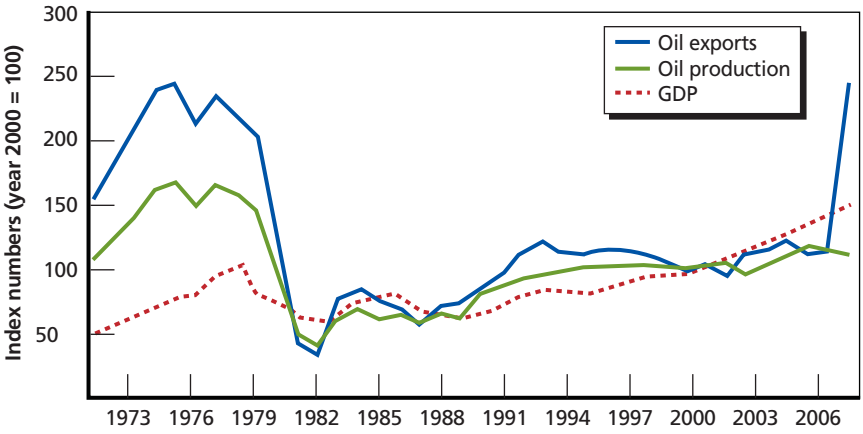
SOURCES: Central Bank of the Islamic Republic of Iran, "Annual National Accounts, 2001–2003," spreadsheet, Tehran, 2006a; IMF, *International Financial Statistics: 1970–2007*, Washington, D.C., January 2007; IMF Country Reports, various years; Planning Council, State of Qatar, "Qatar in Numbers: 2005," Doha: State of Qatar, October 2005.
NOTE: Data on the role of energy in GDP and exports were available only for certain years: for Iran, 2004 (GDP), 2005 (exports); for Algeria, 2004; for Iraq, 2004; for Kuwait, 2005 (GDP), 2004 (exports); for Oman, 2002; for Qatar, 2004; and for Saudi Arabia, 2005 (GDP), 2004 (exports).
RAND *MG693-5.2*

[11] We regressed changes in the volume of oil production on changes in GDP for the period 1971 to 2006. The parameter estimates were

$$\text{Change in GDP} = 2.87 + \text{Change in Oil Output} \times 0.27.$$

T-statistics had P-values of 0.03 and 0.001, respectively. The F-statistic had a P-value of 0.001. There were 35 observations.

Figure 5.3
Iranian GDP, Oil Production, and Oil Exports



SOURCE: EIA, 2007; Statistical Center of Iran, "National Accounts," *Statistical Yearbook 1383 (2004–2005)*, Tehran: National Portal of Statistics, 2006a; Central Bank of the Islamic Republic of Iran, "Economic Trends No. 44: 1st Quarter 1385 (2006/2007)," Tehran, October 2006b; IMF, 2007; IMF, "Islamic Republic of Iran: Statistical Appendix," IMF Country Report No. 06/129, Washington, D.C., April 2006b.
NOTE: All values in real terms converted into index numbers with the value in 2000 set equal to 100. Oil exports were valued in 2006 dollars.
RAND *MG693-5.3*

illustrates this connection: Fluctuations in oil output and exports have been closely correlated with the ups and downs of the Iranian economy. Increases in oil output and exports drove the economic boom of the 1970s; declines were the primary factor in the collapse of the 1980s. To a great extent, the strong economic growth since 1999 has been oil driven.

Oil is even more important as an export than as a contributor to economic output. Oil accounted for over 85 percent of Iran's total export revenues in 2006. Oil exports are also crucial to government finances, accounting for 70 percent of total budget revenues in 2007. The oil industry subsidizes domestic purchases of refined oil products by refining and selling fuels in Iran at less than their market value and by financing imports of gasoline and other fuels that exceed the capacity of the domestic refining industry. Because of price controls, the state-owned oil company, and hence the government, lose money

on domestic sales of these oil products. The cost to NIOC of covering these losses is a major reason that oil accounts for 70 percent of total government revenues.

Iran's economy is highly vulnerable to reductions in oil exports or declines in oil prices on the world market. A sharp drop in oil export volumes or oil export prices would severely dent export earnings, government revenues, and Iran's fiscal balance. When Iranian exports were lowest in the 1980s, budget deficits ran 9.4 percent of GDP.

Iran's dependence on oil exports and revenues is compounded by its inflexible economy. Because of onerous government regulations on business, state ownership and control of the oil industry, government control of the banking system and other sources of finance, and controlled prices on gasoline and other refined oil products, Iran's economy reacts slowly and sometimes counterproductively to economic shocks, especially shifts in oil prices on the world market. Instead of saving its oil windfall during the current period of high oil prices, Iran is squandering it on expensive imports of gasoline and diesel that are resold to Iranian motorists for much less than what the government paid for the fuel. Because prices are fixed and incomes are rising as Iranians benefit from the oil price windfall, Iranian consumers have been consuming more, not less, refined oil products, necessitating increased imports of these fuels. In the past, when oil prices on the world market or export volumes fell, the Iranian government prevented the exchange rate from depreciating or prevented the prices of consumer basics, many of which are imported, from increasing. Because prices did not change, consumer and producer behavior did not shift until the government was forced to respond by restricting supply. Iranian consumers and businesses did not receive signals indicating that foreign exchange was becoming increasingly scarce and failed to respond appropriately. As a consequence, Iran's economy has suffered repeated balance-of-payments crises.

Because oil exports are crucial for financing government expenditures and imports, the Iranian government has strong incentives to increase oil output and pursue high prices. Iran, even under the shah, was considered an oil price hawk. At meetings of the Organization of the Petroleum Exporting Countries (OPEC), Iran has pushed

for higher price targets but has balked at cutting its own production to achieve them.[12] Iranian governments have argued that the richer Arab producers, especially Saudi Arabia and Kuwait, should make the reductions in production needed to keep prices high. There is little evidence that Iranian policymakers, unlike their Saudi counterparts, have thought through the medium- to long-term effects of higher prices on global demand for oil. While the Saudis have been concerned that long periods of high oil prices would encourage the development of non-OPEC oil production, conservation, and shifts to fuels other than oil and hence weaken demand for OPEC oil, the Iranian position has generally been that the higher the price, the better. However, Iran has done little to support prices in the past. Although it has made cuts in production when OPEC has decided that cuts are essential, its policy has in general been one of pumping as much as possible. In the past, when quotas bit, Iran has been known as an OPEC member that perennially cheated on its quota.[13] In recent years, with high global oil demands, Iran has generally failed to fill its quota because of production constraints and domestic demand.

Iran has periodically threatened to use oil as a diplomatic tool. Iran's top nuclear negotiator, Ali Larijani, recently threatened to divert oil sales from countries that are pressuring Iran to abandon its nuclear program.[14] These have been empty threats because the government has needed as much revenue from oil exports as it can get. If oil supplies continue to remain tight, Iran might be tempted to announce a small cutback to push prices up, especially if the Ahmadinejad government thought it would recoup more from higher prices than it would lose through lower export volumes. However, a large reduction in oil export volumes would bring the Iranian government severe financial and bal-

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[12] See "Opec Cuts Exports to Boost Prices," BBC News, December 28, 2001; "Iran Joins OPEC Agreement After Initial Refusal," CNN.com, March 29, 2000; and "Iran Says OPEC Shouldn't Raise Output," AME Info, August 15, 2004.

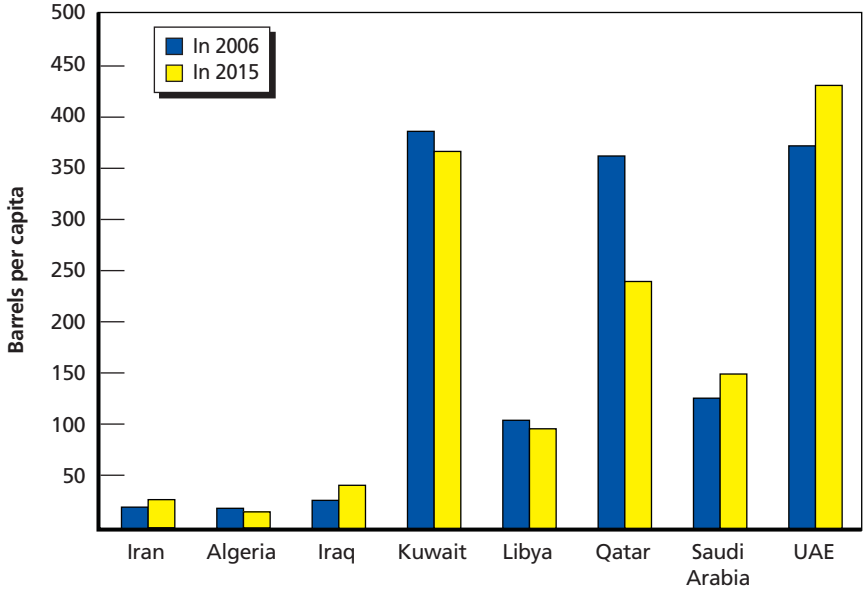
[13] Strategic Forecasting Inc., "Iran and Nigeria Team up to Oppose OPEC," *STRATFOR Global Intelligence Update*, January 13, 2000.

[14] "West Threatens Action on Iran; Iran Threatens Reprisals," Agence France Presse, September 20, 2005.

ance-of-payments difficulties once reserves disappear (foreign currency reserves are currently large enough to cover 12 months of imports).

Because of its large population, oil will not make Iranians rich despite the country's impressive reserves. Figure 5.4 compares per capita oil output in Iran and the countries of the Middle East in 2006 and projections for 2015. By this measure, the less-populous states score best: Per capita output in Kuwait, Qatar, and the UAE in 2006 was over 16 times more than in Iran. Translating production into dollars underscores how diluted Iran's oil revenues become when spread across its large population. If December 2006 prices were to remain stable and Iran succeeded in meeting the aggressive target of 5.0 mbd set by its oil ministry by 2015, the per capita value of Iranian oil production would rise from $1,273 in 2006 to $1,456 in 2015—not much on which to live.

Figure 5.4
Production in Iran and the Middle East



SOURCE: EIA, 2007; U.S. Census Bureau, *International Database,* 2006.

RAND *MG693-5.4*

Despite the dramatic increases in output in the 1990s, natural gas plays a much smaller role than oil in economic output, exports, and government finances in Iran. While gas production has risen steadily, it has not been a major driver of growth in GDP. In contrast to the highly significant correlation between changes in oil output and changes in GDP, neither regressing changes in GDP on changes in the output of natural gas output nor regressing changes in GDP on both changes in output of natural gas and oil yielded a positive correlation between natural gas output and growth in GDP.

As noted above, exports of natural gas are small, 3.3 billion m^3 in 2003, 3 percent of total production; Iran flares three times as much gas as it exports. Iran's immediate neighbors have their own reserves, and Iran has found it difficult to sign agreements and arrange the finance to construct pipelines to reach potential clients further afield. Natural gas contributes more to exports by providing a substitute fuel for domestic consumption, freeing up more oil for exports. For example, the share of gas in domestic energy consumption rose from 26 percent in 1991 to 46 percent in 2001; over the same period, the share of oil declined from 64 to 47 percent.[15] Because domestic energy consumption is highly subsidized, natural gas production contributes little to government coffers.

Nuclear Power

Since the time of the shah, Iranian government officials and analysts have argued for investments in nuclear power, citing concerns about running out of oil.[16] But Iranian concerns about future shortages of oil and gas, although perhaps real, are not grounded in reality. The recent large increases in estimates of reserves, output of natural gas, and oil production make this argument unconvincing. In much of the world, natural gas has become the preferred fuel for generating electric power; the low cost of generating capacity, the ease with which new units can be added, and low emissions of pollutants relative to other

[15] National Iranian Gas Company, "An Overview of the National Iranian Gas Company," Tehran, 2007.

[16] EIA, 2006a.

fuels make natural gas very attractive. If economic considerations were driving investment decisions, Iran, with its large reserves, low production costs, and limited alternative uses for natural gas would focus on building gas-fired generating capacity. In contrast, nuclear power projects have almost invariably been subject to cost overruns that are due to construction problems and regulatory hurdles. Although regulatory hurdles are less of a problem in Iran, the technological and construction problems at Bushehr, the site at which Iran's commercial nuclear generating plant is being constructed, have been formidable to date. Since the beginning of the project in the 1970s, cost overruns have been extraordinary. The contrast between the high costs—financial, economic, and diplomatic—of developing nuclear energy and those for using natural gas for electric power generation leads to the conclusion that cost and economic efficiency considerations have not been driving the civilian nuclear power program.

Key Economic Actors and Their Interests

If economic levers are to be used to influence Iranian behavior, they have to affect the interests and behaviors of key economic actors. We next describe the most important Iranian business groups, government agencies, and political parties; their interests; and their vulnerabilities.

State-Owned Companies

In 1980, the new revolutionary government nationalized major companies in Iran. The state acquired ownership of banks, insurance companies, dams and irrigation works, large-scale manufacturers, radio and television stations, communications and transport companies, and a hodgepodge of companies in other sectors.[17] This policy decision was driven in part by an amalgam of Middle Eastern socialist ideology and Islam and in part to retaliate against business supporters of the shah.

[17] Parvin Alizadeh, "Iran's Quandary: Economic Reforms and the 'Structural Trap,'" *The Brown Journal of World Affairs*, Vol. IX, No. 2, Winter/Spring 2003, p. 272.

Nationalization has given the state a large role in the Iranian economy as owner and manager of Iran's largest enterprises. In many sectors, state-owned enterprises account for a considerable share of value added—70 percent in the case of industry (including the oil and gas sector). State-owned enterprises (including *bonyads*) are the largest single employers after the government.

A number of the more economically damaging policies of the Iranian government stem from state ownership of these enterprises. The state has protected them from competition, the primary force for inducing improvements in productivity elsewhere in the world. It has provided them with inputs at subsidized prices and granted subsidized loans, making it difficult for privately owned Iranian competitors to prosper. It has imposed high tariffs, a complicated import licensing regime, and quotas to protect these enterprises from competition from imports. The state covers the losses of state-owned enterprises through the budget. The scale of losses of state-owned enterprises has been staggering, amounting to over one-half of their revenues between 1994 and 1999, or 2.7 percent of GDP over that period.[18]

State-owned enterprises have provided a fertile field for corruption.[19] Because of the lack of satisfactory controls and audits, managers are able to pocket salaries from nonexistent "ghost" employees, arrange for preferential supply or sales contracts, and transfer funds to favored individuals.

Iran invests a larger share of its GDP than most developing countries, 33 percent in recent years.[20] Because of the role of the state as owner, most of this investment has been channeled to state-owned companies. Many of the projects financed by this capital have lost money or generated low rates of return. The state as owner has wasted investment, resulting in slower growth and lower consumption than would otherwise have been the case.

The state uses state-owned enterprises to generate salaried jobs, jobs that due to their security and relatively high wages are coveted by

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[18] Alizadeh, 2003, p. 273.

[19] Alizadeh, 2003, pp. 275, 277.

[20] IMF, 2007, pp. 23.

Iranians. As a consequence, state-owned enterprises are heavily overmanned. Despite this, they continue to hire at the behest of the state, even while losing money. Even so, state-owned enterprises have failed to generate enough jobs to keep up with the expanding workforce. In the 1990s, 70 percent of new jobs came from the private sector, despite the large role state-owned enterprises play in the economy.

The *Bonyads*

Not all expropriated property ended up in the hands of the state. Revolutionary organizations called *bonyads* were set up after the 1979 Revolution to safeguard the ideological orientation of the Islamic state and redistribute money to poor and rural inhabitants.[21] They were given assets seized from the royal family, exiled elites, and some nationalized assets. Although they operate in the name of the dispossessed, *bonyads* function like parastatal conglomerates. IMF has suggested that the largest, the Bonyad-e-Mostazafan va Janbazan [Foundation of the Oppressed and Injured], be classified as a holding company rather than a philanthropic foundation.[22] *Bonyads* are active in manufacturing, agriculture, and industry. Although not accountable to the government (or anyone except the clerics who control their boards of directors), *bonyads* have been the beneficiaries of considerable subsidies, explicit and implicit, including subsidized loans and access to subsidized imports and inputs. *Bonyad* losses have imposed substantial costs on the budget and the Iranian economy. The *bonyads'* privileged position has engendered discontent from competitors, especially in the private sector, who do not enjoy their special status. In contrast, individuals favored by the clerics who control the *bonyads* or their management enjoy employment and positions they might not otherwise attain.

During the Mohammad Khatami presidency, a number of economic policy changes were introduced to create a more-level playing field among state-owned enterprises, the *bonyads*, and the private

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[21] Alizadeh, 2003, p. 273.

[22] IMF, "Islamic Republic of Iran: Staff Report for the 2004 Article IV Consultation," IMF Country Report 04/306, Washington, D.C., September 2004b, p. 46.

sector. Although access to subsidized inputs was curtailed, *bonyads* still have preferential access to loans.

The Private Sector: *Bazaaris*, Industrialists, and Small Business

The true private sector in Iran consists of three groups. The *bazaaris* are businessmen and their families who engage in wholesaling, retailing, and transport. Some of these families have ancient roots, especially in cities like Shiraz and Isfahan. In some instances, *bazaaris* have had close ties, financial and political, with the religious leadership. The second group, industrialists, consists of entrepreneurs who have branched out from the bazaar into other businesses, including manufacturing and business and financial services. They differ from *bazaaris* primarily in terms of the sectors in which they operate. The third group, small-scale businesses, consists primarily of sole proprietorships. Most of the Iranian labor force works for or operates a small business or sole proprietorship. Many small entrepreneurs are poor, relying on themselves and their families to staff their businesses. Their interests differ from those of the *bazaaris* and larger industrialists because they lack the resources and political connections to obtain favorable treatment from the government or state-owned banks. They are among those who suffer most from the corruption and the stifling regulatory systems in Iran.

Successful entrepreneurs have found it difficult to increase the size of their operations and transform them into modern corporate entities because it is often hard to obtain financing from the state-controlled banks, import freely, and hire and fire workers. Private companies are also wary of attracting the attention of the tax and religious authorities and try to avoid controversy. Islamists within the regime have attacked "big capital" and "profiteering." Wealthy businessmen without ties to the regime have been jailed under trumped-up charges for becoming too successful.[23] Most businessmen therefore cultivate supporters within the religious and political leadership to forestall political difficulties. Many have offered bribes or other "contributions" to ensure that support.

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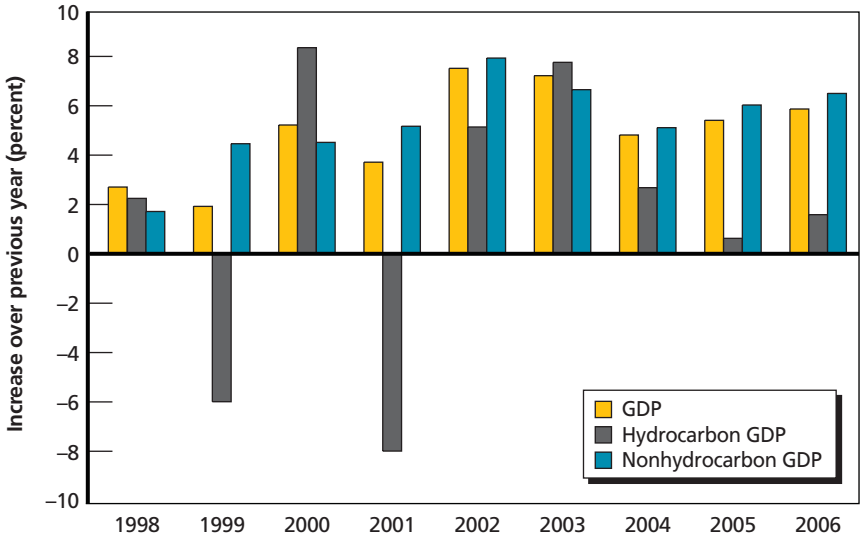
[23] Alizadeh, 2003, p. 279.

Some private companies depend on import protection or government contracts to stay profitable or rely on access to state-controlled banks for loans. These entrepreneurs attempt to curry favor with the regime.

Economic Growth

Since the oil bust of 1998–1999, the Iranian economy has grown rapidly. Between 1999 and 2006, GDP rose 49 percent, an average annual rate of 5.8 percent per year; per capita GDP has been rising at 5.3 percent per year (Figure 5.5). Some of this growth has been due to increases in oil output and in oil prices on the world market. Between 1999 and 2006, oil output rose 13.3 percent, a little more than one-fourth the

Figure 5.5
Iranian GDP Growth Inside and Outside the Energy Sector



SOURCE: IMF, "Islamic Republic of Iran: Staff Report for the 2002 Article IV Consultation," IMF Country Report 02/211, Washington, D.C., September 2002, p. 30; IMF, 2006b, pp. 3–4; IMF, Islamic Republic of Iran: Staff Report for the 2005 Article IV Consultation," IMF Country Report 06/154, Washington, D.C., April 2006a, p. 24; Central Bank of the Islamic Republic of Iran, 2006b.

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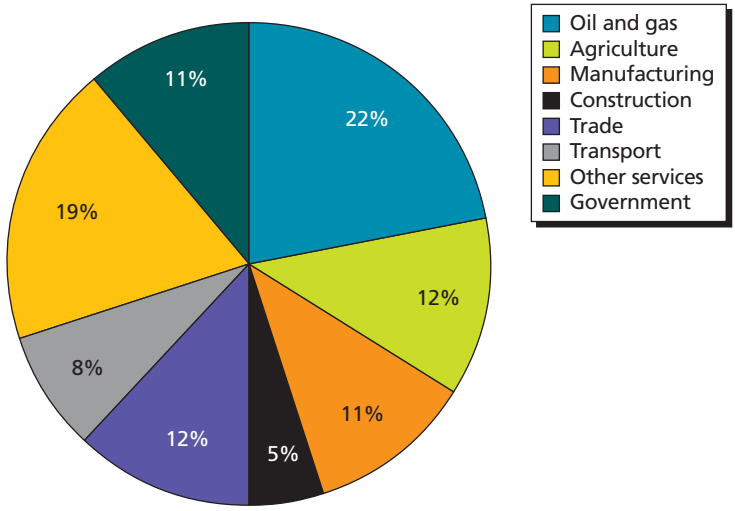
increase in GDP. Export prices for Iranian oil have risen much more rapidly, from an average of $16.81 a barrel in 1999 to $59.82 in 2006. As a result, oil export revenue more than tripled between 1999 and 2006.

Despite the correlation between growth and changes in oil output and exports, the diversity and complexity of Iran's economy extends beyond the energy sector. As noted above, oil and gas account for only 23 percent of GDP. Services are the largest contributor to economic output, accounting for close to 50 percent of the total. Agriculture and manufacturing account for 11.6 and 11.2 percent of GDP, respectively (Figure 5.6). Although Iran's manufacturing sector is more muscular than those of other oil-exporting economies in the Middle East, its share of GDP is small relative to those of such developing countries as Brazil, China, India, and Mexico, where manufacturing often accounts for three times the share in Iran.

Figure 5.6
Composition of Iran's GDP



SOURCE: Central Bank of the Islamic Republic of Iran, 2006a.

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Since 1989, when the economy began to recover in the aftermath of the Iran-Iraq war, output from sectors other than hydrocarbons has grown more rapidly than in the hydrocarbon sector in most years. Since 1997, increases in the output of the construction industry, financial services, and communications and transportation have been very rapid, averaging from 7 to 24 percent annually. Much of this growth reflects improvements in productivity or the creation of new services. In contrast, some of the growth in manufacturing and agriculture has relied on high tariffs, subsidized inputs, and other government interventions. Increases in economic activity in these sectors are less healthy because they have depended in part on the government's ability to provide subsidies, which in turn depends on oil exports and oil prices on the world market.

In a simplified characterization of a nation's economy, growth is driven by increases in labor, capital, and the productivity of both these factors of production. Increases in labor are generated by a rise in the number of people of working age, higher rates of labor-force participation among this group, or declines in rates of unemployment. Increases in capital are driven by investment. Improvements in productivity are a consequence of a variety of factors, including the introduction and adoption of new technologies, improvements in management and resource allocation, and gains from trade. Labor inputs may increase because the number of workers has risen or because greater investments in education and training—in human capital—have improved the productivity of the workforce.

According to an IMF paper,[24] improvements in human capital due to higher levels of education have been the most important contributor to growth in Iran since the 1960s.[25] Drawing on this paper, we

[24] Abdelali Jbili, Vitali Kramerenko, and Jose Bailen, "Islamic Republic of Iran—Selected Issues," Washington, D.C.: IMF, August 27, 2004, pp. 6–7.

[25] Jbili, Kramerenko, and Bailen created two growth accounting frameworks for Iran, the first using "raw" labor and the second accounting for improvements in human capital that are due to education. Under the first set of estimates, increases in the capital stock contributed an average 2.1 percentage points to Iranian growth of 4.6 percent between 1960 and 2002; raw labor contributed 1.4 percentage points, and increases in total factor productivity contributed 1.1 percentage points. Replacing raw labor with an estimate for labor inputs

estimated that increases in human capital accounted for 40 percent of the rise in Iranian GDP between 1960 and 2002; increases in labor, 24 percent; and increases in physical capital, 36 percent. Factoring out the contribution of increases in human capital to GDP growth, productivity growth from other sources was negative, falling 1.2 percentage points per year over this period. This is a disheartening result; growth in the productivity of capital and labor is the key driver of growth in the rest of the world. Iran's poor performance in this area is a consequence of the distortions in the operation of the country's markets and its poor regulatory environment. If per capita incomes are to continue to rise, increases in productivity will have to accelerate. This will necessitate reducing these distortions.

Economic Policies

Policies on Trade, Exchange Rates, Foreign Debt, and Foreign Direct Investment

The Khatami government recognized the importance of improving productivity to accelerate growth and introduced a number of policies designed to do so. His government had much to improve on. After the fall of the shah, the revolutionary government adopted an amalgam of Islamist and Middle Eastern socialist economic policies that resulted in the deterioration of productivity in Iran. The most detrimental of these policies pertained to foreign trade, the exchange rate, and consumer price subsidies. Iranian economic growth and improvements in economic welfare continue to be held back by misguided policies in these areas.

After the fall of the shah, the Iranian government created a complicated, highly inefficient system of import licensing. Nothing could be imported without a license granted by one of the sectoral ministries (Agriculture, Industry, etc.), and only goods placed on a "positive

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incorporating improvements in human capital increases labor's contribution to 3.7 percentage points, and the growth in total factor productivity becomes –1.2 percentage points. We combined the two sets of estimates to break out separate contributions of raw labor and human capital.

list" could be imported; those not on the list were banned.[26] Favored individuals and businesses were granted licenses, often in exchange for bribes; those without close connections to the government were not. The government set up a multitier exchange-rate system. Favored individuals were permitted to purchase foreign exchange at the advantageous official rate to import designated items, especially subsidized consumer goods. All other Iranians had to purchase their foreign exchange at market rates, which were as much as five times higher than foreign exchange purchased at the official rate.

The Khatami government liberalized a number of trade restrictions and unified the exchange rate. Sectoral ministries lost the right to issue import permits for most products; these are now issued by the Ministry of Commerce. Approvals are now almost automatic, greatly reducing incentives and opportunities for bribery. The positive list has been greatly expanded. Quotas on sensitive goods are being replaced by tariffs, permitting more competition from imports. Replacing quotas with tariffs and reducing average tariff rates are prerequisites for membership in the World Trade Organization (WTO), one of the Iranian government's policy goals. Although the process of obtaining an import permit has become less expensive, less cumbersome, and more equitable, Iran remains protectionist; engaging in foreign trade is still difficult.

The single most effective policy reform during the Khatami presidency was the unification of the exchange rate. The multiple exchange rate regime ended in March 2002, after which all international transactions have been conducted at one, unified rate. By unifying the exchange rate, the government has leveled the playing field among importers and between importers and producers. Unification of the exchange rate may have added 7 percent to the real incomes of Iranian households by reducing the cost of less-favored imports and permitting

[26] Jesper Jensen and David Tarr, "Trade, Foreign Exchange, and Energy Policies in the Islamic Republic of Iran," working paper, Washington, D.C.: The World Bank, No. 2768, January 2002, p. 5.

more-efficient providers to prosper at the expense of less-efficient producers and importers.[27]

Tax, Regulatory, and Subsidy Policies

The Khatami government also made some progress in improving the environment for private business. Marginal corporate and personal income tax rates were cut sharply in 2002, from 64 to 25 percent. A national sales tax of 3 percent was introduced that consolidated a number of previous taxes and fees. To combat corruption and improve the business climate, government officials were given less discretion in assessing and collecting taxes. Four private banks were licensed, and for the first time since 1979, laws permitting foreign investment were passed.[28]

The Khatami government also planned to expose state-owned enterprises to competition from the private sector and to privatize a number of these entities. Plans for privatization were ambitious. By 2003, the Privatization Committee had reviewed the status of 1,039 public-sector enterprises that were candidates for privatization. Of these, it decided that 735 should be privatized, 217 should remain in state hands, and 87 were to be liquidated.[29] But progress on privatization has been slow. Although privatization began in the mid-1990s, the government has often not divested majority control but has sold minority stakes to favored private investors or to the *bonyads.* In July 2006, Ayatollah Khamenei provided a new impetus to privatization, issuing an executive order to privatize 80 percent of the remaining state-owned enterprises by 2015.[30]

However, the proposed privatization procedures look like they may entrench rather than break the control politically powerful indi-

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[27] Jensen and Tarr, 2002, p. 16.

[28] IMF, "Islamic Republic of Iran: Staff Report for the 2003 Article IV Consultation," IMF Country Report 03/279, Washington, D.C., August 2003, p. 7.

[29] World Bank, *Iran: Medium Term Framework for Transition, Converting Oil Wealth to Development*, Country Economic Memorandum, Washington, D.C., No. 25848-IRN, April 30, 2003, p. xxvii.

[30] IMF, 2007, p. 11.

viduals exert. From 40 to 60 percent of shares in smaller, profitable state-owned enterprises will be sold on highly preferential terms to holding companies that have a strong resemblance to the *bonyads*. Proceeds will be allocated to the poor. The government will continue to hold a 20-percent stake. This approach to privatization has not led to effective corporate governance and improved efficiency in other countries that have tried this tactic.[31]

Progress on exposing state-owned enterprises to the real brunt of competitive forces is likely to continue to proceed slowly. Currently, state-owned enterprises are still able to purchase energy at subsidized prices and receive favorable treatment from state-controlled banks. On the other hand, because the exchange rate has been unified, they no longer receive preferential treatment in terms of imports.

Khatami made little progress on the most egregious remaining economic distortion perpetuated by the Iranian government: massive consumer price subsidies. Iran sells refined oil products domestically (gasoline, diesel fuel, kerosene, and fuel oil) at prices that average less than 10 percent of market value.[32] Gasoline went for about 42 cents a gallon in early 2007. This is up from 34 cents a gallon in 2006. The increase merely reinstates a Khatami government decision to raise refined oil product prices by 23 percent in 2004, which the Majlis rolled back.[33] Energy subsidies, explicit and implicit, ran 17.5 percent of Iran's GDP in 2006.[34] Because prices have been fixed, the subsidy expands as world market prices of refined oil products rise, as has been the case in recent years. In addition to energy, Iran subsidizes wheat, rice, vegetable oils, sugar, milk, cheese, medical equipment and pharmaceuticals, fertilizers, and service payments on debts that have been publicly guaranteed. These explicit subsidies equaled 7.5 percent of GDP in 2006.[35] Iranians, especially the poor, would be much better off

[31] IMF, 2006a, p. 20.

[32] Jensen and Tarr, 2002, p. 19.

[33] IMF, 2004b, p. 17.

[34] IMF, 2007, p. 14.

[35] IMF, 2007, p. 14.

if these subsidies were eliminated and replaced with payments targeted at them. Because the poor consume less gasoline and diesel fuel than higher-income Iranians, their real incomes and consumption would rise sharply if these subsidies and the resulting waste of resources were eliminated.

Because of constraints on refining capacity and technological deficiencies (Iranian refineries are able to convert only 16 percent of a barrel of crude into gasoline; Western refiners can convert 32 percent), Iran imports gasoline and diesel to satisfy domestic demand. Iran has been taking money from its rainy-day account, the Oil Stabilization Fund, to pay for the increased costs of imported gasoline and other fuels.[36]

Because of political pressures, the Khatami government failed to reduce these subsidies. Poorer Iranian households were not convinced that other types of government assistance would compensate for increases in prices for subsidized goods. Managers of industries that rely heavily on subsidized energy—including ferrous metals, copper, aluminum, chemicals, and motor vehicles—opposed the reduction in subsidies because it would increase the costs of inputs. As a consequence, the Iranian economy remains extraordinarily energy intensive: Consumption of oil in Iran is similar to that of Spain, whose GDP is six times that of Iran.[37]

Fiscal pressures are forcing the Iranian government to grapple with the problem of energy subsidies. In June 2007, the government introduced electronic ration cards for gasoline. Ahmadinejad preferred rationing to price increases. Riots followed the introduction of rationing, but the unrest has since dissipated.[38]

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[36] EIA, "Country Analysis Briefs: Iran," Washington, D.C.: U.S. Department of Energy, March 2005.

[37] Jbili, Kramerenko, Bailen, 2004, p. 36.

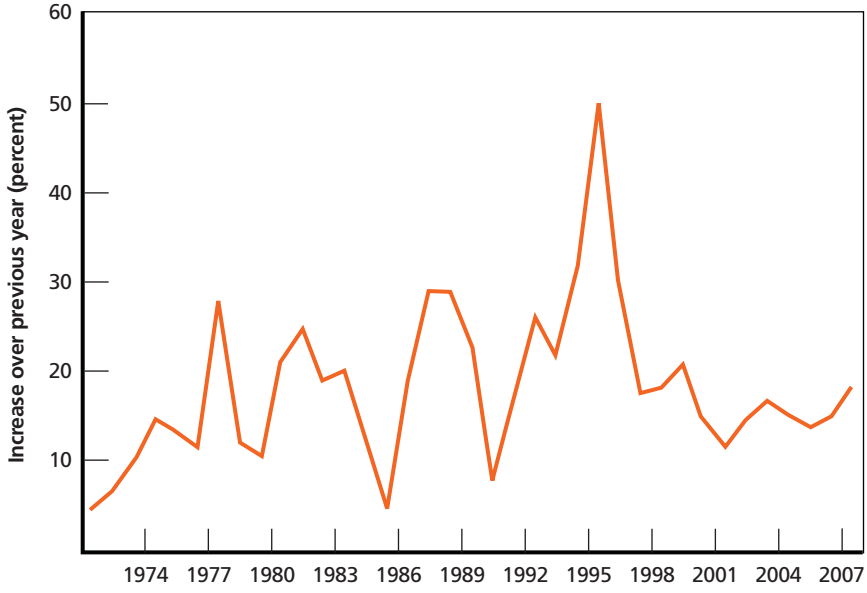
[38] Nazila Fathi and Jad Mouawad, "Unrest Grows Amid Gas Rationing in Iran," *International Herald Tribune*, June 28, 2007.

Monetary, Fiscal, and Financial-Sector Policies

Iran has had a poor record on inflation. In the 1990s, performance deteriorated: The average annual rate ran 24.0 percent, up from 12.7 percent in the 1970s (Figure 5.7). Since 2000, consumer price inflation has averaged 14.7 percent per year. It accelerated to 18.0 percent in 2007.

The cause of inflation in Iran, as everywhere, has been increases in the supply of money issued by the central bank.[39] However, ascribing inflation solely to the policies of a central bank leads to the question of why the bank has been printing so much money. In the case of Iran, the problem has been institutional and budgetary. Institutionally, under Islamic banking principles as interpreted by the Iranian regime,

Figure 5.7
Consumer Price Inflation in Iran



SOURCE: IMF, 2007.

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[39] Olin Liu and Olumuyiwa S. Adedeji, "Determinants of Inflation in the Islamic Republic of Iran—A Macroeconomic Analysis," working paper, Washington, D.C.: IMF, WP/00/127, July 2000, p. 17.

borrowers cannot be charged a fixed interest rate, which is considered usury. The official interpretation of Islam in Iran prohibits usury. Investors and lenders are permitted a return, but the rate of return is not supposed to be set at the time the loan is issued but is determined after the investment has generated a profit. Under this interpretation, a borrower who successfully invests the proceeds from a loan and generates a high rate of return would pay a higher interest rate than one who squandered the loan on an investment that failed. Interest rates are not adjusted for risk. In practice, however, borrowers are charged an anticipated rate of return on the investment. The central bank and financial institutions issue central bank participation and government participation paper that provide an "expected rate of return," what is, in essence, an interest rate.

Because of the Iranian antipathy toward usury and, more important, the desire of the authorities to provide subsidized credits to politically powerful borrowers, both the central bank and the government prefer to keep interest rates below rates that equilibrate the market. Many rates are fixed, often at rates considerably below the rate of inflation, making interest rates negative in real terms. In March 2006, the government made a counterproductive policy change, cutting interest rates on loans from state-owned banks from 16 to 14 percent and capping the rates private banks offer at 17 percent despite accelerating inflation.[40] Below-market interest rates increase investment demand and discourage saving. Consequently, demand for funds is generally higher than available savings in Iran, contributing to the inefficient allocation of investment. Just as important, below-market interest rates have contributed to inflation.

Just as important for monetary policy, the government makes many decisions on the allocation of investments in Iran. The government has been providing credits at less-than-market rates of interest to state-owned enterprises and the *bonyads* for favored investments and to make sure that payrolls are being met. In many instances, the government has not had the cash or desire to fund these investments and has turned to the central bank to supply the requisite funds. These loans

[40] IMF, 2007, p. 9.

from the central bank have been a major cause of Iran's higher inflation rates. The effects of infusions of money on inflation are exacerbated by the relatively low level of demand for rial deposits. Because rial interest rates are negative in real terms, Iranians prefer to keep their cash in dollars or other foreign currencies. Consequently, an increase in the money supply depreciates the market rate for rials and accelerates inflation.

Economic Policy Under Ahmadinejad

As noted above, the Khatami government made some progress toward creating a more-resilient Iranian economy through economic liberalization. Key policy successes included the unification of the exchange rate, liberalization of imports and exports, and some privatization. However, it left a number of detrimental policies in place. It failed to significantly raise prices on refined oil products. It did not reduce subsidies on foods and fertilizer. It continued to prop up loss-making state-owned enterprises. As a consequence, implicit and explicit price subsidies absorb 25 percent of GDP.

The centerpiece of Ahmadinejad's campaign was protection of the poor. He and his economic advisers harkened back to the economic assumptions and policies that nationalist, socialist groups espoused in the 1970s and that had been at the heart of the economic policies of Iran immediately following the Islamic Revolution: state ownership, controlled prices, subsidies, and opposition to foreign investment. During the campaign, he promised to redistribute Iran's oil wealth, hold down the prices of consumer basics, raise government salaries, and increase the benefits the state provides to the poor.[41] Although Ahmadinejad is known as a religious conservative, his campaign focused on bread and butter issues more than on cultural ones. Campaign speeches included such statements as: "People think a return to revolutionary values is only a matter of wearing the headscarf. The country's true problem is employment and housing, not what to wear."[42] He called for raising

[41] Michael Slackman, "For the Poor in Oil-Rich Iran, the Voting for President Was About Making Ends Meet," *New York Times*, July 2, 2005, p. 9.

[42] "Who Is Mahmoud Ahmadinejad?" *The Socialist*, No. 7, July 13, 2005.

the incomes of low-income workers and tightening state control of the oil industry, "putting the petroleum income on the people's tables." He also vigorously attacked corruption and foreign investors. "I will cut the hands off the mafias of powers and factions who have a grasp on our oil, I stake my life on this. People must see their share of oil money in the daily lives," he said. He also initially threatened to close Tehran's "ungodly" stock exchange and promised to cut interest rates and give the poor large holdings in state-owned companies. These messages resonated with lower-income voters, both urban and rural.[43]

Ahmadinejad has made some more-conciliatory statements concerning private investors since his election. He has said that

> [o]ne of the main topics of our economic policy is the expansion of foreign and domestic investment. . . . We will especially use our dear Iranians [currently living abroad] who are ready to take part in developing their country . . . the stock market will definitely be promoted, but of course there should be some reforms.[44]

He has also committed to continuing many of Khatami's reforms, including additional reductions in tariffs and, as noted above, privatization of state-owned enterprises. However, actions speak louder than words. Ahmadinejad has adopted a host of detrimental economic policies during his tenure, including forcing the central bank to cut interest rates at a time of accelerating inflation; targeting loans to favored firms; resorting to fuel rations rather than reducing the fuel price subsidy; and sacking competent economic policymakers, such as the governor of the central bank and the Minister of Oil. The proposed new privatization program appears to be a recipe for rewarding regime supporters and preserving state control. In short, economic policy in Iran has moved backward under Ahmadinejad.

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[43] Lynn Walsh, "Hardliner's Victory Stuns Western Leaders," *The Socialist*, No. 7, July 13, 2005.

[44] "Iran's New Man—In His Own Words," BBC News, June 27, 2005.

Economic Policy Vulnerabilities

Despite reforms, the Iranian economy remains inflexible because of the many remaining severe distortions. Government policies designed to foster domestic industries through import protection have backfired because inefficient domestic producers have shown themselves to be incapable of competing on international markets. Perversely, these policies have made the country even more reliant on oil for both exports and tax revenues. Controlled prices for gasoline and other fuels have artificially increased demand and imports, straining the budget and wasting resources. Subsidization of foods has discouraged the cultivation and production of competing food products. Lack of government fiscal discipline when oil prices and exports are high has exacerbated the ensuing busts.

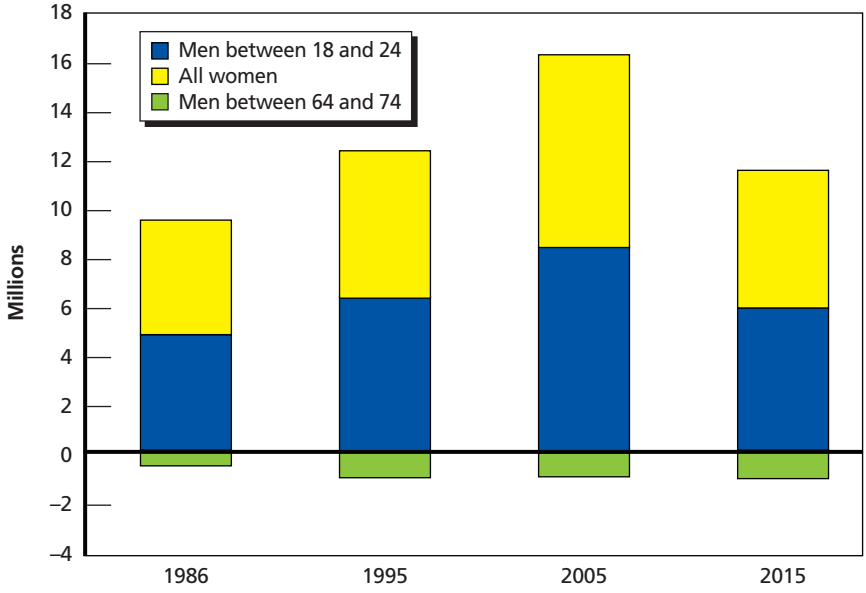
The Ahmadinejad government appears unlikely to pursue economic policy measures that would liberalize the Iranian economy and thereby improve productivity growth and living standards. Ahmadinejad campaigned on promises to uphold and extend the current system of subsidies and income supports. Under his tenure, the Iranian government is likely to continue to pursue misguided economic policies, and the Iranian economy is likely to remain inflexible.

The Iranian Labor Market

Supply

Although the rate of population growth in Iran has slowed, the children born during the baby boom of the 1980s are now becoming adults and entering the labor market. Figure 5.8 shows the sizes of the cohorts of young men and women, aged 15 to 24, who are potential new entrants into the labor force, for 1986, 1995, 2005, and 2015. The cohorts have been rapidly increasing in size. In 2005, 16.4 million men and women were in this group, 6.9 million people more than in 1986. Between 1985 and 2005, the influx of young people resulted in rapid growth in the labor force. In the first decade of the 21st century, the working-

Figure 5.8
Joining and Exiting Iran's Working Age Population: Numbers of Iranians Between 15 and 24 and Men Between 65 and 74



SOURCE: U.S. Census Bureau, 2006, 2007.

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age population has been increasing by over 2.5 percent per year, with 750,000 young people entering the labor market each year.[45]

Shifts in attitudes toward work and gender are contributing to rapid growth in the labor force. Young women now study longer and marry later. These women look for jobs before marriage, adding to the number of new entrants. Increased female participation in the labor force returns to patterns before the Islamic Revolution. During the 1970s, the numbers of women in the Iranian labor force rose substantially, reaching 12.9 percent of the female population of working age in 1976. After the fall of the shah, the revolutionary leadership strongly discouraged women from working: Female labor force participation

[45] IMF, 2007, p. 6.

fell to 8.2 percent in 1986.[46] It has since risen, reaching 14.8 percent by the end of the 1990s. This rate is still one of the lowest in the Middle East and North Africa region, which in turn has the lowest rates in the world. But the addition of young women to the labor force has increased the numbers of new entrants seeking work by as much as 3.7 percent per annum between 1995 and 2005. Female labor-force participation rates are projected to continue to rise, keeping the rate of increase in the labor force high.[47]

The number of new entrants peaked in 2006 and will begin to decline sharply after 2010, reflecting Iran's "baby bust" of the 1990s. After 2010, pressure new entrants have put on the job market will ease. By 2015, the number of Iranians between 15 and 24 will have fallen back to 11.5 million, the same as in 1992. The number of individuals exiting the labor force will also be rising. By 2015, close to 2 million Iranian men will be over 64, compared to 1.3 million in 1995. Most of these men will have retired, opening up job opportunities for new entrants.

Not only are more young people looking for work, their aspirations are higher, and their skills are markedly different from those of young Iranians in the past. During the Iran-Iraq war, Iran became poor; per capita GDP fell 59 percent between its peak in 1977 and its nadir in 1988. Occupational opportunities were limited; so were aspirations. Since the economic rebound of the 1990s and because of higher levels of education, aspirations have risen.

As in many Middle Eastern countries, youth, especially educated youth, look to the government for employment. Despite an increase in educational attainment, secondary school graduates frequently lack skills in demand on the job market. Although only 10 percent of secondary school graduates go on to university, high schools focus on preparing students for college. They fail to provide students with skills in demand by employers.[48] Because of the status ascribed to a university

[46] Djavad Salehi-Isfahani, "Demographic Factors in Iran's Economic Development," *Social Research*, Vol. 67, No. 2, Summer 2000, pp. 4–5.

[47] World Bank, 2003, p. 13.

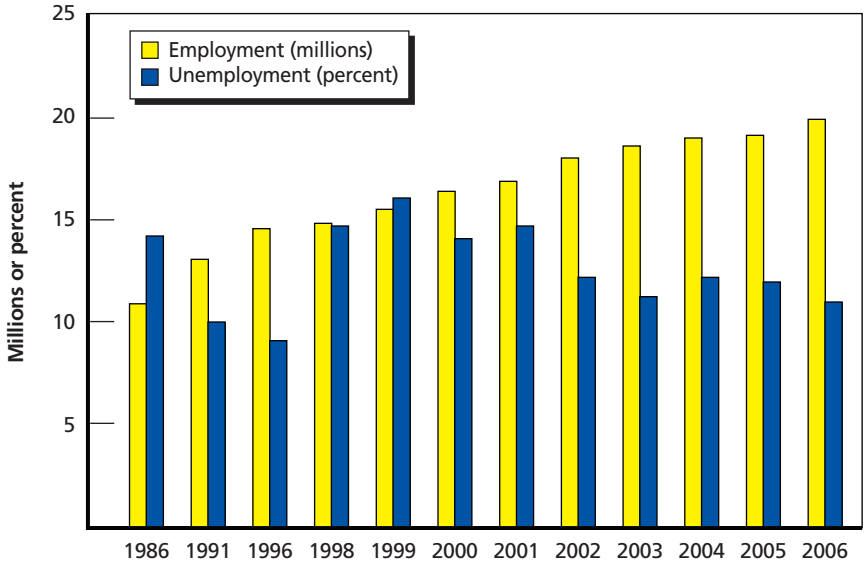
[48] Salehi-Isfahani, 2000, pp. 7.

education, many young people choose to study and retake the entrance exam for one or two years after graduation rather than search for a job that does not demand a university diploma. These young people are in limbo, neither working nor in school. The Iranian government has reduced the number of public-sector jobs available, exacerbating the mismatch between the number of positions available and those desiring them, disappointing both young people and their families.

Demand

Despite highly publicized concerns about unemployment, employment growth in Iran has been quite strong over the past few years. Between 1999 and 2006, employment rose at an average annual rate of 3.6 percent, more rapidly than the rate of increase in the labor supply. Total employment reached 19.8 million in 2006 (Figure 5.9). All this growth has come from the private sector. Budgetary pressures and privatization

Figure 5.9
Employment and Unemployment in Iran



SOURCE: IMF, 2007; International Monetary Fund, 2006b; Central Bank of the Islamic Republic of Iran, "Economic Trends," various dates.

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have led to a reduction in public-sector employment: The number of employees in the government and in state-owned businesses dropped by 261,000 between 1997 and 2000, to about one-quarter of total employment.[49] This is a major change in employment patterns, as after the Islamic Revolution, the state and nationalized enterprises became the primary employers.

In addition to generating over three-quarters of GDP, the nonoil sector provides virtually all employment in Iran. Oil, gas, and electric power are capital-intensive industries; state-owned companies in this sector are large, but employ a small fraction of the Iranian labor force. Private-sector employment is concentrated in services. Iranian wholesalers, retailers, truckers, and purveyors of personal services are the biggest employers in the country and add the most value.

Unemployment

Because of rapid increases in employment between 2000 and 2007 and rapid growth in GDP, the unemployment rate fell from 16.0 percent in 1999 to 10.2 percent in 2007. Despite the strong recent record on job growth, unemployment is a major political issue for the Iranian government. Since 1979, generating employment for the influx of new entrants into the labor force has been one of the most pressing social and economic problems the government has faced.

Part of the problem with unemployment stems from government policies: The Iranian government has very strict regulations on dismissals; severance pay; and, in the state-owned sector, wage regulations. These policies make it difficult for firms to adjust their workforces and, in the state-owned sector, to attract and motivate good employees. As a consequence, private-sector employers are often reluctant to hire, and state-owned enterprises lack funds for expansion and for attracting productive employees. Even during booms, the number of jobs rises less than in countries with similar per capita GDPs but more-efficient labor markets. In Iran, a 1-percent increase in GDP increases employment by 0.5 percent; in countries with more-efficient labor markets,

[49] IMF, 2003, p. 17.

a 1-percent increase in GDP will often increase employment by 0.7 percent.[50]

Poverty, Incomes, and Income Distribution

The World Bank classifies Iran as a lower-middle-income developing country. Per capita GDP ran $3,570 in 2006; in 2005, Iran ranked 107th among the 208 countries for which the World Bank provides data on per capita incomes.[51] The World Bank measures abject poverty as living on less than $1 per day and poverty as living on less than $2. By these measures, Iran is not a poor country: Less than 1.5 percent of the population lives on less than $2 per day. Using Iranian definitions of poverty, the share of the poor in the total population ran 21 percent in 2002, compared to 26 percent in 1990. So, growth in the 1990s through 2005 has reduced poverty.[52]

Iran's success in reducing poverty is due to the extensive social programs the government has financed and past investments in education, which have yielded high levels of literacy, improving the human capital of the workforce.[53] Government funding and programs have boosted child immunization against major diseases to 99 percent. However, infant and child mortality rates remain high relative to other Persian Gulf states, at 39 deaths per 1,000 children under five, compared to 27 in Saudi Arabia and 12 in Kuwait. In more-developed countries, child mortality runs around 4 deaths per 1,000 children under five.

Although poverty is low, income distribution in Iran is skewed toward the wealthy: The 10 percent of Iranians with the highest incomes account for 45 percent of consumption.[54] Because income distribution is skewed, the Iranian government's policy of providing universal sub-

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[50] IMF, 2004b, p. 24.

[51] World Bank, "GNI Per Capita 2004, Atlas Method and PPP," Washington, D.C., 2006.

[52] IMF, 2004b, p. 6.

[53] In 2002, 98 percent of men and 95 percent of women were literate; Statistical Center of Iran, "Population Estimation by Urban and Rural Areas: 2005," Tehran: National Portal of Statistics, 2006b.

[54] Statistical Center of Iran, 2006b.

sidies for sensitive products is a highly inefficient way to reduce disparities in income because it benefits both the rich and the poor.

The current boom does not appear to have reduced income inequality, although it has increased average per capita incomes and employment. As the government has shed labor, employment has, perforce, grown primarily in the informal private sector. Payment within the informal private sector is often by the day or by the job; workers do not receive a salary or a steady paycheck. Despite the increases in incomes, individuals employed in the informal sector would often prefer a more-secure source of income.

Prospects

The Outlook for Energy and Implications for the Iranian Economy

Currently, Iran faces a relatively rosy outlook for energy production and exports. Prices are high and likely to remain so in the near term. Gas production continues to rise, and oil output has remained around 4 mbd. Despite NIOC's many inefficiencies, a combination of increased investment, improved management, better-trained staff, and more-effective use of foreign contractors has allowed the company to sustain output successfully.

The Iranian government is optimistic about Iran's potential to increase its oil output. It plans to raise production to 5.0 mbd by 2009 and 7.0 mbd by 2024.[55] The U.S. Department of Energy is more pessimistic, projecting only 3.8 mbd in 2010 and 4.0 mbd in 2015 and 2025. These figures are slightly below the average output between 2005 and 2007.

Even the government of Iran does not promise substantial growth in oil output. The Iranian projection implies that the oil sector will grow at an average annual rate of 5.2 percent through 2009 but by only 2.9 percent through 2024. U.S. Department of Energy projections suggest that Iranian oil production will fall through 2010, then

[55] EIA, 2005.

gradually return to but not exceed current levels.[56] Neither forecast suggests that oil will be much of a base for economic growth unless oil prices continue to rise.

The Outlook for Growth in the Rest of the Economy

If Iranian per capita incomes are to grow, the country cannot rely solely on oil. Oil provides the government with revenues and eases balance-of-payments pressures but is not a long-term source of rapid economic growth. The key to sustained, rapid growth is improving the productivity with which both capital and labor are used.

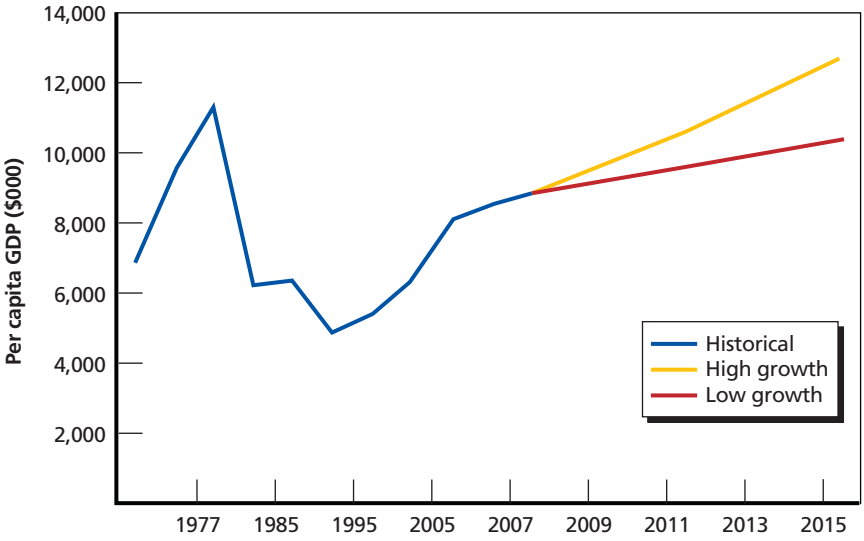
After three decades of declines, Khatami's economic reforms appear to have increased gains from trade and improved productivity, especially that of labor. The rate of growth in the nonoil sector accelerated after their adoption. The Khatami government also benefited from the improved levels of human capital in Iran, a product of the Iranian government's investments in education, extending back to the last shah's father. Levels of education in Iran have improved immensely as a result.

Some Iranian economic policymakers understand the deleterious effects of current policies on Iranian economic growth. They have pushed for Iranian membership in the WTO, liberalization of prices, removal of restrictions on trade and investment, and a stronger role for Iran's central bank. If these policy changes were introduced, Iran could very well maintain the average annual growth rate between 2000 and 2007, 5.6 percent. Under this scenario, by 2015 GDP would be almost two-thirds higher than in 2006, and per capita GDP would have risen by one-half (Figure 5.10). Most of this growth would be generated by the nonoil sector. In this scenario and using the Iranian government's projected increases in oil output, the oil sector would account for only 12 percent of the increase and the nonoil sector, 88 percent.

The economic policies of the Ahmadinejad government will be a more important determinant of Iran's future economic growth than oil prices. But further economic policy changes, especially reductions in subsidies on fuels, are likely to proceed slowly under his government,

[56] EIA, 2006b, p. 155.

Figure 5.10
Potential Growth in Iran's Per Capita GDP



SOURCES: IMF, 2007; Central Bank of the Islamic Republic of Iran, "Economic Trends," various years; World Bank, "GNI Per Capita 2004, Atlas Method and PPP," Washington, D.C., 2006b.
NOTE: Measured in constant 2005 dollars at purchasing power parity exchange rates.
RAND *MG693-5.10*

retarding economic growth. If Iran were to lapse back into the slow growth of the period between 1992 and 1997, when growth averaged 3.0 percent per year, per capita GDP in 2015 would only be 23 percent higher than in 2006, not 50 percent more (Figure 5.10). Budgetary and employment pressures would mount rather than ease, leading to continued frustration among Iran's young job seekers with employment and career opportunities. Unfortunately, in light of Ahmadinejad's current economic policies, once the current oil boom ends, this scenario now appears most likely.

CHAPTER SIX

Iranian Vulnerabilities and Implications for U.S. Policies

This chapter briefly recaps the vulnerabilities (or lack thereof) that the Iranian regime faces. We then assess the likely repercussions of military actions against Iran for the economic and political environments in which the regime operates. We conclude with a set of modest policy recommendations that might serve to nudge the Iranian leadership toward less-antagonistic policies toward the United States by supporting ongoing changes in Iranian society, assuming military actions are avoided.

Vulnerabilities

Because of its ability to mediate among differing political forces and the importance it gives to democratic forms, the Iranian regime has successfully diffused political pressures for systemic change that had built up over the course of the 1980s and 1990s. By allowing elections while vetting political candidates, arresting regime opponents, and forcibly putting down demonstrations, the bifurcated Iranian government has been able to avoid serious levels of unrest. As shown by voting behavior, the majority of the population, including most members of the major ethnic groups, accord the government a substantial degree of legitimacy. At this juncture, the government faces no imminent threat of collapse or coup.

Ethnic cleavages persist in Iran, but they do not provide an easily utilized avenue for swaying Iran's leadership. Although Persians, the dominant group, account for only one-half the population, Iranian governments have been relatively successful in inculcating an Iranian identity into citizens from most other ethnic groups by emphasizing Shi'ism as a unifying force and cultivating Iranian nationalism. The Iran-Iraq war played a key role in reinforcing Iran's national identity across most ethnic groups, with the exception of the Kurds. The regime has used perceptions of foreign interference in Iranian politics, especially the 1953 restoration of the shah, to foster Iranian nationalism. Iran's long history, a history that most of its ethnic groups share, especially the Azeris, contributes to a common Iranian identity. Public opinion polls suggest that foreign pressure to discontinue Iran's nuclear program has contributed to a rise in patriotism because public support for the Iran's nuclear program has been strong. Support for the program transcends political factions and ethnic groups.[1]

Although many Iranians are dissatisfied with the authoritarianism of the regime, few have been willing or prepared to act outside the electoral process. Public questioning of the legitimacy of the current system has declined over the past few years, as the government has cracked down on the media. Facing tough restrictions on the ability to meet and form political groups, those who oppose the political system and favor greater democracy have been unable to organize effectively. Opponents of the regime who are willing to use force, such as the MEK, are largely discredited and in exile.

Iran's political system is not immutable. Iranians who push for change may become more willing to take risks as frustration grows or as the sense that change is becoming possible takes root. Slow growth in employment or declining incomes could increase the ranks and resentment of disaffected groups. If Iranians take to the streets, the government might have to deploy the IRGC and the Basij, a move the regime wishes to avoid but one that would most likely effectively quash resistance. The security forces have successfully put down demonstrations in recent years. Over the course of the next few years, politi-

[1] Author's interviews of Iranian scholars, 2005; Iranian Web log entries.

cal change in Iran is more likely to occur gradually and as a result of internal debate, elections, and maneuvering than through violent confrontation.

Likely Domestic Consequences of U.S. Military Actions Against Iran

A number of commentators have discussed how military force might be used to force the Iranian government to change policies that run contrary to U.S. interests.[2] In this section, we use the analysis of Iran's politics and society that we have laid out here to evaluate the likely repercussions inside Iran if the United States were to employ military force against that country. Because other RAND studies have addressed Iranian nuclear policies, involvement in Iraq, and the development of Iran's armed forces in great detail, we do not delve into these topics in this monograph.

Attacking Iranian Nuclear Installations

A number of commentators have discussed or advocated bombing Iran's nuclear facilities, especially the nuclear fuel enrichment plant.[3] News accounts claim that if the United States does not bomb these facilities, Israel may.[4] What might be the political ramifications in Iran of bombing these facilities?

As noted above, support for Iran's nuclear program extends across the political spectrum. A large majority of Iranians strongly believe that Iran has the same right as other nations to develop nuclear energy, including the construction and operation of nuclear enrichment facilities. If Iran's facilities were to be bombed, public support for retaliation would likely be widespread. If U.S. forces were to be involved, the

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[2] See, for example, Norman Podhoretz, "The Case for Bombing Iran," *Commentary*, June 2007.

[3] Podhoretz, June 2007.

[4] Uzi Mahnaimi and Sarah Baxter, "Revealed: Israel Plans Nuclear Strike on Iran," *The Sunday Times*, London, January 7, 2007.

current positive view in Iran of the United States would take a decided turn for the worse. Bombing installations or targets other than nuclear facilities would have an even more detrimental effect on popular opinion in Iran toward the United States. An Israeli action would also have a detrimental effect on popular Iranian opinion of the United States because Iranians would see the attack as having had the blessing of the United States, although the turnabout in public opinion might be less precipitous than in the event of a U.S. attack.

Bombing Iran's nuclear facilities would have financial repercussions both for Iran and for the rest of the world. The Iranian government would be able to limit capital outflows over the short term. However, fairly quickly, richer Iranians, such as the *bazaaris*, would find the means to transfer more of their wealth outside the country. Poorer Iranians would shift more of their assets from dinars to euros, gold, or dollars. Private domestic investment would take a hit.

Outside Iran, oil prices would spike, and investor confidence in the Persian Gulf region, especially in the smaller states with close ties to the United States, would plummet. Iran might respond by blockading exports of Iraqi oil, further exacerbating economic problems in that country.

At current oil prices, an attack would be unlikely to stop the Iranian program. The government would be able to finance the reconstruction of the facility and continue the current program without major budgetary consequences.

The political ramifications within Iran of an attack are less clear. Ahmadinejad has come under fire from other politicians for baiting the United States. An attack might be perceived as his comeuppance. In our view, a more likely response would be a strong push to retaliate against the United States (or Israel). Critics of such a policy would likely choose to keep silent.

U.S. Military Responses to Iranian Involvement in Iraq

Since the fall of Saddam, the Iranian government has become increasingly engaged in Iraq. Iran has been funding and training Shi'ite militias; is the source of shells for explosively formed projectiles, the most lethal improvised explosive devices; and has funded and supported Iraqi

political parties that it perceives as aligned with its interests.[5] Explosively formed projectiles have killed many U.S. soldiers and marines. Support for Shi'a militias has exacerbated violence in Iraq.

Iranian society has been fairly insulated from the violence next door, although some of the hundreds of thousands of Iranian pilgrims to Najaf and Karbala have been targets of car bombs. Iraqi refugees have fled to the west, not to the east, as Sunni Iraqis have fled Baghdad for Jordan and Syria. Displaced Shi'a have usually stayed within Iraq. With the exception of Basra, the governorates bordering Iran have been among the more peaceful in Iraq. Because so much of the Iranian government's activities in Iraq are covert, these aspects of Iranian policies toward Iraq have not been the subjects of public debate.

If confined to Iraq, U.S. retaliatory measures against Iranian activities and agents in Iraq would be unlikely to elicit much response from the Iranian public. U.S. countermeasures in Iraq against Iranian activities do not appear to affect the Iranian economy. It is less clear how these measures affect Iranian intelligence services or internal debates within the Iranian leadership. Substantial setbacks within Iraq might persuade the Iranian leadership to scale back its efforts. On the other hand, the intelligence services might just absorb their losses and continue to pursue their current activities.

In contrast, attacks on Iran proper would generate a great deal of ill-will and, in our view, would be unlikely to change Iranian policy. The initial response of this Iranian leadership would likely be to intensify covert activities against U.S. forces in Iraq and elsewhere.

Blockade of Iranian Oil Exports

Most of Iran's oil exports are loaded at Kharg Island; all go through the Straits of Hormuz. A blockade or destruction of the Kharg Island facilities or closure of the Straits of Hormuz to shipments of Iranian oil would effectively halt most Iranian exports. Maintaining a blockade until Iran's foreign currency reserves were depleted would have a dev-

[5] Gen David Petraeus, "Testimony to the House Armed Services Committee," September 10, 2007; Lionel Beehner, "Iran's Involvement in Iraq," backgrounder, Washington, D.C.: Council on Foreign Relations, February 12, 2007a.

astating effect on the Iranian economy and Iranian living standards. Destruction of Kharg Island would hit the Iranian economy hard for a number of years.

Because a blockade is an act of war, the Iranian government would likely respond accordingly. A blockade would probably do more to solidify public support for the regime than weaken it. During the Iran-Iraq war, living standards plummeted. Yet opposition to the war was muted because most Iranians rallied around the flag.

A blockade would sharply increase oil prices on the world market both because of the drop in the supply of oil and because of concerns that the conflict would escalate. Iran would probably respond by attacking tanker traffic through the Persian Gulf. Depending on the circumstances, other nearby producers might refrain from increasing output in fear of or solidarity with Iran. The sharp rise in oil prices on the world market because of the massive disruption of oil exports from the Gulf would probably push the world economy into recession.

U.S. Policy Options for Influencing Iran

Our assessment of political, demographic, and economic conditions and trends in Iran suggests that the Iranian regime is, at least in the near term, likely to be relatively stable and resistant to external pressures for dramatic change. Politically, the new president is anti-American and anti-Western and sees confrontational policies as a way to foster political support. Ethnic minorities are in no position to successfully oppose the regime. Population growth rates have moderated. Higher oil prices and the better economic policies of the late 1990s have made Iran's economy the strongest it has been since the rule of the shah.

On the other hand, Iranian society is becoming more modern: Educational levels have increased dramatically with this generation. Citizens participate in the political process: They vote and expect their government to be responsive to their concerns. Information flows relatively freely, at least through the Internet. The public media engage in debates over a wide range of policies. Incomes are rising, and consumer

spending is shifting toward patterns typical of more-developed countries. More women are participating in the labor force. In contrast to the Arab Middle East, the United States is popular in Iran.

During the Khatami government, many Iranians and U.S. policymakers had hopes that social and economic pressures to liberalize would lead to a more-open, democratic Iran. Although these hopes were not realized, long-term trends still suggest that Iran has the potential to become more democratic and less obdurate.

Assuming that the United States avoids military actions against Iran, U.S. policies vis-à-vis the Iranian government need to be designed with these conditions in mind. Economic, social, and political trends in Iran favor an eventual shift toward a more-democratic government, a more-open economy, and a less-confrontational relationship with the United States. Coercive strategies are possible and could achieve some specific policy goals, but if the U.S. government wishes to move Iran toward a more generally cooperative stance, it will need to focus on encouraging tendencies and policies that favor the expansion of economic and personal freedoms in Iran. Broadly speaking, the U.S. government has opportunities to encourage Iranians, including members of minority ethnic groups, to push to expand civil liberties and democratic practices in Iran. Working through international financial institutions, the U.S. government also has the ability to encourage policy changes in Iran that would liberalize the economy, thereby potentially strengthening the private sector and weakening the sway of the religious establishment. To successfully pursue such policies, however, the U.S. government will need to minimize policy measures that the Iranian government can use as a pretext for clamping down on Iranians seeking more liberties in Iran.

Such a strategy will not yield immediate fruit; its ambitions will need to be modest. As long as relations remain hostile, U.S. initiatives will need to be pursued more deftly than they often have been.

U.S. policy toward Iran should be predicated on supporting trends that expand the freedoms and independence of the Iranian citizenry from the political establishment while penalizing members of the government that pursue policies antithetical to U.S. interests. Below, we provide some suggestions on how to pursue these goals. We have

divided policies into three categories: those designed to increase U.S. engagement with Iranian society, those designed to broaden the sphere of independent activity in Iran, and those designed to penalize individuals and institutions within the Iranian regime that engage in activities harmful to the United States.

Policies for Engaging with Iranian Society

Facilitate Increased Contacts Between Iranians and Americans. Because the United States and Iran do not have diplomatic relations, traditional U.S. government programs connecting people in Iran with those in the United State are in abeyance. These range from the Fulbright program, which funds academic exchanges, to programs for high school students and for teachers of English. In other countries, these programs have had major payoffs. Many ministers in the new governments following the fall of communism in Central and Eastern Europe were former Fulbright scholars. Ongoing exchanges involving high school students in Europe, Latin America, and Asia have created a group of dynamic young people who have experience with and fond feelings for the United States. Even countries with which the United States has less-than-cordial relations, such as Syria, have participated in these programs.

Once the current crackdown in Iran moderates, the U.S. government should more aggressively fund programs focused on facilitating contacts, especially educational and other exchanges, between Iranians and Americans.[6] Where necessary, it should modify existing programs so that Iranians would be eligible for participation even in the absence of diplomatic relations with Iran. If the Iranian government chooses to forbid its citizens from participating in these programs, Iranians would put the blame for their inability to participate where it belongs: on the Iranian government.

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[6] In 2007, Iranian security forces detained four U.S. citizens who had immigrated from Iran and captured a boat of British sailors. Although all the British sailors and two of the Americans had been released as of this writing, the current climate is inopportune for greatly expanded initiatives involving contacts with Iranian society.

By the same token, the U.S. government should examine ways in which to ease the process by which Iranians are granted U.S. visas. It should adjust current policies so that Iranians are not barred from getting visas because of difficulties in meeting such requirements as face-to-face interviews with consular personnel, which are more suitable for countries with which the United States has diplomatic relations.

Expand Efforts to Engage in Public Diplomacy, Especially with Minority Ethnic Groups. The U.S. government should make a concerted effort to get American voices heard on media channels to which Iranians listen. This includes the BBC World Service and other channels available over satellite. However, the U.S. government should also attempt to get American voices onto the state-controlled television and radio stations as well. Persian-speaking American citizens should be encouraged to participate in online discussions and contribute to Iranian Web logs.

Because Iran's ethnic groups tend to be more supportive of human rights and devolving authority, the Kurds, Azeris, Baluch, Turkmen, and Arabs are potential forces for political change. The U.S. government should make a concerted effort to get Americans heard through existing media channels in the languages of these groups. The U.S. government should also expand Voice of America and other U.S. government-supported radio broadcasts into Iran in Azeri, Kurdish, Baluch, and Arabic to update these communities on internal Iranian developments and government activities. The U.S. government should also provide open forums through radio, the press, and the Internet that will allow these groups to discuss Iranian political problems and to press for more democratic practices and greater regard for human rights. Ethnic minorities are likely to find allies in this campaign among ethnic Persian intellectuals, youth, women, and the ranks of Shi'a clerics who have doubts about the role of the religious establishment in government. U.S. government policy should encourage these ethnic groups to interact with the larger Iranian polity by providing radio call-in programs in Persian and other languages spoken in Iran.

U.S.-government–funded radio broadcasts could articulate and encourage discussion of key social issues in Iran, including the problems arising from poor-quality government services and high housing

costs. Call-in shows have been surprisingly successful throughout the Middle East. The advent of cell phones makes participation easy. These programs would help disseminate information on the state of services and the Iranian government's lack of responsiveness to urban problems. Call-in programs can also highlight corrupt practices. Policy discussions about increasing the authority of local governments serve to widen the space for democratic forces in Iran.

Dissatisfaction with housing costs and urban services, especially if directed toward the factors responsible for the current state of affairs—government policies and administrators—could easily sway future elections. For example, discussions about how increasing government sales of urban land would increase the supply of housing and limit further price rises could help push a policy change that would also reduce the power of government bureaucrats to demand bribes in exchange for access to land. By highlighting these problems and providing venues for discussion of such potential policies, the U.S. government can foster Iranian policy debates.

Funding for these programs should be incorporated into broader budget categories, not special funds for Iran. The Bush administration's request for $75 million in supplemental funding to promote democracy in Iran has had negative repercussions. Following that announcement, some Iranian dissidents who attended international workshops about democracy in Iran were jailed when they returned home. Other activists pushing for greater democratization within Iran were also threatened or jailed. The Iranian government accused these individuals of collaborating with the United States. By funding these programs through the normal appropriations process and incorporating funds for Iran into larger regional programs, the ability of the Iranian government to exploit U.S. policy announcements for their own ends would diminish.

Policies for Weakening the Iranian Government's Ability to Clamp Down

Mute U.S. Policy Statements on Regime Change. At this juncture, we do not see regime change through a violent domestic uprising as plausible. The current regime is fairly stable: Economic and

demographic pressures have eased, and internal security forces appear capable of handling any incipient unrest. In this context, U.S. policy statements calling for regime change are more likely to serve the interests of Iranian government agencies interested in cracking down on those who advocate expanding civil liberties rather than to advance U.S. policy interests. U.S. policy statements would be more effective if they focused on expanding human rights and democracy in Iran rather than on replacing the existing regime.

Discourage Ethnic Groups from Violently Opposing the Iranian Regime. Although most members of Iran's minority ethnic groups have no wish to violently oppose the regime, some members of these groups periodically turn to violence. To date, these incidents have ended with the capture, expulsion, or death of the individuals involved. The U.S. government should discourage these activities. The Iranian government has convincingly and repeatedly shown that it has the ability and will to employ its security forces to quash violent opposition to the regime. Such opposition is more likely to enhance the standing of the security and political forces that currently dominate Iran than to change regime policies.

In this regard, the United States should work with the Iraqi government to disband the MEK by finding homes for its members in countries other than Iraq. The organization poses no threat to the Iranian government but serves as a useful propaganda tool for the regime in internal discussions about external threats. The organization also appears to abuse its members. Working with the Iraqi government to disband it would be in the best interests of the United States and Iraq.

U.S. support for Iranian ethnic groups should focus on helping them engage more effectively in Iranian politics rather than serving as potentially violent irritants to the regime. In this regard, the U.S. government should use its leverage with Kurdish groups to dampen Iranian Kurdish aspirations for independence or secession. The Kurdish people have suffered from violent repression in all four countries in which they reside (Iran, Iraq, Syria, and Turkey). Previous attempts by Iranian Kurdish groups to secede or become more autonomous have failed. Future efforts are unlikely to be successful.

The U.S. government should make it crystal clear that it will not support secessionist groups in Iran. Aside from forestalling bloodshed, such a policy would have the added benefit of potentially allaying some Iranian government concerns about secessionist movements or at least make it more difficult for the government to use such threats, real or imagined, as pretexts for persecuting its domestic political opponents. Iranian religious leaders and the intelligence services have used threats of secession to restrict human rights, especially those of ethnic groups.

Encourage the Development of Markets in Iran. Often lost in the discussion of economic sanctions and their effects on the Iranian economy is the question of the effects of greater prosperity on political developments in Iran and the degree to which the Iranian regime might be able to tap increased output for its own purposes. The implicit assumptions of those who advocate broad economic sanctions is that reduced economic output weakens the Iranian regime. But if the regime cannot capture the increased output or even if most of the increased output ends up in the hands of private individuals, the regime's hold on the country would weaken rather than strengthen. In particular, the more freedom and resources the private sector has to operate independently of the regime, the less economic power the regime will have over these individuals.

The Iranian economic policies of the 1980s helped entrench the revolutionary regime, while making individual Iranians poorer. State-owned companies, private entrepreneurs allied with the government, and *bonyads* have provided funds for regime supporters. These organizations have also slowed economic growth because of the inefficiencies that they perpetuate in the economy. If other actors have the freedom to pursue their own economic interests without kowtowing to the regime, both political and economic freedoms would expand.

The U.S. government has some modest policy levers that it can employ to strengthen the role of markets in Iran, which, in turn, would improve the position of entrepreneurs and make workers less beholden to the state.

Support IMF and World Bank Efforts to Encourage Better Economic Management in Iran. Because the U.S. government has no dip-

lomatic relations with the Iranian government, it has to work through other states and international institutions to pursue its policy goals. IMF and the World Bank probably have had the most influence of any outside institutions on Iranian economic policies in recent years. The U.S. government should support the interactions of both institutions with the Iranian government, including financing: Loans are likely to lead to more-liberal economic policies.

Iran has had a prickly relationship with IMF. IMF does not have any active programs with Iran but does evaluate economic performance and policies as part of its regular responsibilities, often critically. The Khatami government heeded a number of IMF recommendations. Under the Ahmadinejad presidency, Iran appears to be more resistant to following IMF economic policy recommendations, although the government contends that it is continuing with policies to privatize, lower inflation, and reduce subsidies.

The World Bank has offered Iran $719 million in loans for improved sewage treatment, reconstruction efforts in Bam after the earthquake, environmental management, housing, and health care. The bank has also offered technical assistance for reforming Iran's system of subsidies and welfare. The Khatami government discussed economic policies, including subsidy and welfare policies, with both the World Bank and IMF. The bank still has some influence with Iranian civil servants concerning economic policies in these areas.

Through its position as a major shareholder in both institutions, the U.S. government can encourage IMF and the World Bank to continue to engage with Iran. Because of Ahmadinejad's aversion to markets, the current dialogue with Iran will probably be less fruitful than under Khatami, but further economic liberalization would serve the interests of U.S. policy by eroding the Iranian government's economic controls and expanding the space in which Iranian entrepreneurs can operate.

Do Not Oppose Iran's Accession to the WTO. A more-liberal, more-dynamic Iranian economy would serve U.S. interests. It would foster the development of companies and institutions that would be more independent of the government. It would free more Iranian youth from dependence on the regime for jobs and careers. It would also

increase Iranian personal incomes because private-sector growth would channel resources into the pockets of individuals rather than to the government, reducing their economic dependence on the government.

If the Iranian government continues to pursue membership in the WTO, the U.S. government should not impede Iranian membership. Although the U.S. government may use U.S. acquiescence to Iranian membership as a bargaining chip in other negotiations, the U.S. government would benefit greatly from an Iran that is more open to international trade in goods and services. WTO membership would make it more difficult for the Iranian government to impose import quotas and exchange rate regimes that it could manipulate for the benefit of its supporters. WTO membership also helps ensure access to imports for Iranian entrepreneurs, supporting the emergence of a more independent entrepreneurial class.

The U.S. government has a strong interest in fostering a more vibrant, open labor market in Iran. The United States cannot easily harness the discontent that the current system fosters to push the Iranian government toward decisions conducive to U.S. interests. On the other hand, if the dead hand of the Iranian government on the labor market can be removed, the power of the government and *bonyads* to reward their supporters with jobs will decline, and the independence and wealth of economic actors who are not in the pocket of the regime will rise.

Policies for Penalizing the Iranian Government or Its Officials for Pursuing Policies that Harm the United States

Maintain the Embargo on Iran on Gas Liquefaction and Gas-to-Liquids Technologies. The United States should preserve its embargo on sales of key technologies to Iran as a bargaining chip with the Iranian government, especially the embargo on gas liquefaction and natural gas–to–liquids technologies. Although Iran appears to be becoming less vulnerable to embargoes on oil exploration and extraction technologies as it becomes more sophisticated at finding and producing oil, it still lacks the sophisticated technologies needed to liquefy natural gas or convert it into liquids. These are owned by a small group of Western multinational energy companies. The embargo on exports of these

technologies is likely to significantly impede Iran from developing its natural gas resources for export, thereby stopping the development of a new source of funds for the Iranian government. On the other hand, even a more-widespread embargo on oil exploration and production technologies is unlikely to constrain Iranian oil production in the near future, especially if oil prices remain high.

Expand Contingency Plans to Seize Iranian Foreign Accounts. The Iranian government is well aware of its reliance on oil exports. It has attempted to cushion its vulnerability to a cutoff in oil exports or a sharp decline in oil prices on the world market by creating a financial cushion from unanticipated oil revenues. Some of these assets are in Western banks; others are in banks in countries that are less likely to take hostile actions against Iran.

Freezing Iranian financial assets, whether those of the government, of institutions that support Hizbollah, or of key individuals, would cause some financial losses for the Iranians. It would disrupt payments for imports, travel, and other financial transactions. However, the disruption would be short-lived unless all major countries agreed to enforce the policy. If major banks in China, India, or Russia were willing to handle Iranian funds and make purchases on Iran's behalf, it would be nearly impossible for the United States, Europe, and Japan to prevent Iran from conducting routine financial transactions, including payments for imports. Targeted Iranians and Iranian institutions have already taken some steps to protect themselves by moving assets to institutions outside of Europe and the United States. As new patterns for conducting financial transactions develop, the economic cost to Iran of relying on banks outside of Europe, Japan, and the United States would decline, reducing the financial consequences.

Encourage U.S. Allies to Bar Selected Iranian Officials from Obtaining Visas. The inability to travel to Europe and other U.S. allies was reportedly particularly irksome to the Libyan government and had some influence on Libya's decision to improve its relations with the United States. A targeted program would penalize those who are responsible for decisions that have been especially harmful to the United States. However, the policy would have to be implemented with

care so that it would not complicate attempts to engage in discussions with key Iranian policymakers on issues of mutual interest.

Concluding Remarks

The U.S. government is often accused of having a short attention span. But the United States has successfully pursued long-term policies with great success—to name just four, the containment of the Soviet Union, the integration of Central and Eastern Europe into NATO and the European Union, support for economic development and the emergence of democracies in East Asia, and preventing North Korean hostilities against South Korea. In the case of Iran, the U.S. government will need to play with an eye for the long term, dealing with the current government but also encouraging more discussion among Iranians and more contacts and interactions among Iranians and Americans. Societies and governments change. U.S. government policies toward Iran could help foster favorable trends, but these policies will take time to come to fruition.

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