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3 June 2009

Online at <https://mpra.ub.uni-muenchen.de/15546/>

MPRA Paper No. 15546, posted 04 Jun 2009 06:20 UTC

# Macroeconomic Populism in Iran

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## Abstract

This paper uses the Dornbusch and Edwards (1990) analytical framework to investigate the macroeconomic populism in Iran under the Ahmadinejad government. My thesis endeavours to place the government of Ahmadinejad in a populist context and forecasts its fall mainly due to macroeconomic instabilities. The purpose of this study is to illustrate how closely Ahmadinejad's government follows the model of Dornbusch and Edwards (1990).

**JEL classification:** H11; O53; O11

**Keywords:** Iran; Populism; Ahmadinejad; Economic Growth

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Extremism does not have a place in the popular government. It will be dealt with. All powers and abilities, all opportunities and all competencies, will be used in the popular government. The focus will be on national interests, national honour, and progress for all.

*Mahmoud Ahmadinejad, 26 June 2005*

With the forming of the ninth government (Ahmadinejad's government) the death knell of intellectualism was sounded.

*Emad Afroogh, head of Majlis Commission for Cultural Affairs,  
29 April 2006*

## **1. Introduction**

Throughout history Governors of developing countries have relied on different tools to consolidate their power. While at times, ruling classes have used only military repression to deter any threat of revolution, in other cases they have relied on income transfers to the poor in order to control them, halting potential efforts on regime change. Despite the global trend towards democracy, neo-liberal policies and the fall of dictators in different parts of the world, there is no guarantee that no new populist leaders will emerge. On the contrary, most of the countries in the Middle East experience economic cycles where concurring episodes tend to repeat themselves. The potential threat and concern is the repeated use of populist macroeconomic policies to cure the problems of income inequality, despite the existence of historical examples and evidence of their harmful results. Populism in the Middle East is financed by abundant natural resources such as oil and gas. The governments of these countries rely heavily on the revenues that come from these resources in order to implement their populist programs.

In the Iran of today, we once again observe the emergence of a populist regime. The Islamic Republic of Iran initially claimed to serve the needy in society. However, this plan to reduce the economic gaps between rich and poor was not successful and gradually ceased after the destructive war with Iraq.

The economic development plans after the war required a huge amount of capital. Less attention was paid to the needy classes of society and the importance of an effective distribution policy. Subsequently, by turning a blind eye to the side-effects of economic liberalization on the masses, populism saw a fresh recovery, some 27 years after the victory of the Islamic Revolution.

Iranians have learned that incomes generated through natural resources like oil and gas go hand in hand with corruption in their country. The corrupted state is something that is documented in Iranian history and people have tried to find a willing individual within the government who really wants to combat this systematic corruption and nepotism. This situation creates the context for a special kind of leader to emerge, a person who shows interest in the needs of the middle and lower social classes of society and promises to address corruption and nepotism issues directly and aims to redistribute the wealth which its people considers their right, especially those from oil funds.

My thesis endeavours to place the government of Ahmadinejad in a populist context and forecasts its fall mainly due to macroeconomic instabilities. I apply the Dornbusch and Edwards (1990) framework in order to analyze the current situation and the future probable position of Ahmadinejad's government in Iran. In sum, the purpose of this study is to illustrate how closely Ahmadinejad's government follows the model of Dornbusch and Edwards (1990).

The rest of this paper is as follows. Section 2 introduces the concept of "populism" and explains the model of Dornbusch and Edwards (hereinafter D&E framework). I will discuss the various phases of a populist regime in the D&E model. Section 3 deals with the case of Iran. It describes how the country's social and economic situation led to the emergence of a populist. I will then explain how the Ahmadinejad government fits within the framework of the populist model. Section 3 also describes Ahmadinejad's policies and details their probable effects on the economy. Section 4 concludes the paper.

## **2. Defining macroeconomic populism**

Defining populism has proved to be a difficult task. According to Knight (1998), populism in Latin America has been intimately related to means for obtaining (and maintaining) political power. Roberts (2000) notes that *"In essence, populism is an informal alternative to institutionalized forms of political representation,... provided by political parties"*.

According to Di Tella (1965), paternalism is an essential component of populism which is characterized by *"a political movement which enjoys the support of the mass of the working class an/or the peasant, but which does not result from the autonomous organizational power of either of these two sectors"*. The populism is a set of economic policy measures (or promises) directed towards obtaining support from "the masses".

In terms of a political approach, perhaps the definition of Weyland (2001) is better than the others because it shows the nature of populists: *to win and exercise power, while using economic and social policy as an instrument for this purpose*. According to this definition, populism is much more like a tool used by dictators who aim to remain in power for personal benefits rather than serving their poor subjects, as they would have them believe. The populist leader is charismatic and wins broad and intense support from a largely unorganized mass by representing people who feel excluded or marginalized from national political life and by promising to rescue them from crisis, threats and enemies (Weyland 2001).

From various kinds of definitions of populism, "macroeconomic populism" is a newer concept. D&E (1990) used this term and showed that policy experiences in different countries and periods share common features: initial conditions, motivations for policies, different domestic conditions, and ultimate collapse. Their model is not a righteous assertion of conservative economics, but rather a warning that populist policies will ultimately fail; and when they fail it is always at a frightening cost to the very groups who were supposed to be favoured. D&E (1990) provide a set of properties to explain populism and define a common process. Their model also establishes a link between the behaviour of populist regimes and its effects on the macroeconomy. The extreme vulnerability and instability of the populist regimes are, by and large, the result of unsustainable policies. The D&E model does not explain why the populist leaders behave the way they do. With their model, however, we can examine the decisions populists make and how these decisions affect the macroeconomy.

### ***2.1. Properties of populist leaders and populist policies***

Many populists have an attachment to a specific part of a country or to a specific social class such as the working, middle or the agricultural classes. Populists are usually skilled at rhetoric and claim to be representatives of all the people, trying to find a foreign enemy in order to cover their own weaknesses and mismanagement in domestic affairs. A populist leader tends to design a set of plans in order to realize some special political interests, including:

- a) Organizing support from lower middle class groups and organized labour. These groups represent the regime's primary support because of the high level of discontent with income inequalities.
- b) Isolation of elites, rural oligarchy and foreign enterprises. In a populist regime, these groups are seen as enemies and rent-seekers who have no regard for the lower classes in society. They are also assumed to operate against the populist

regime within the domestic economy, trying to hamper the trend of serving needy people through the regime. In fact, the interests of such groups tend to conflict with the redistributive aims of the populist state (Coupal, 2003).

In order to meet populist leaders' goals, they usually follow some specific economic policies in the country (Coupal, 2003) such as:

- a) Fiscal deficit to stimulate domestic demand.
- b) Increase in the nominal wage accompanied by price controls and huge subsidies.
- c) Control or appreciation of exchange rate to reduce inflation by increasing the volume of imports and to increase the income and profits of sectors that are not involved in international markets.

## ***2.2. Phasing the Populist Macroeconomy***

D&E (1990) identified the initial conditions for the appearance of a populist regime and four phases of its life. In the following sections, I analyze the initial conditions and the four phases of Iran under Ahmadinejad.

### *a) Initial conditions*

In order to establish a populist regime, three initial conditions are required. The first is that the country has experienced slow growth, stagnation, or depression. The second issue is the readiness of people for fundamental changes in economic programs because of high income inequalities and corruption in the country. The third initial condition is having enough room for highly expansionary programs which require sufficient external balance and reserves. Without the required reserves for fiscal manoeuvre, the populist regime cannot initiate its economic plans. Providing the abovementioned initial condition is present, populist regimes may be set in motion and implement their populist economic programs.

### *b) Phase 1*

In this phase, the economy experiences lower levels of unemployment, higher output and real wages. High levels of imports make it easier for the populist regime to control inflation in spite of the expansionary fiscal and monetary policies. Usually, the major source for financing imports is rooted in high revenues from natural resources.

*c) Phase 2*

In this phase, the economy faces a first challenge. Due to the strong expansion in public demand, the country runs into growing shortages of foreign exchange reserves which have been used for considerable imports in the former phase. It is now the time of introducing industry protection, devaluing the currency, and adjusting the prices. In this phase, we observe the increase of inflation and wages. Furthermore, a large number of subsidies and gross inability on the part of the government to control its increasing expenditures put a great burden on government budgets and worsen the budget deficits.

*d) Phase 3*

The main features of this phase are pervasive shortages, an extreme increase in inflation and a considerable foreign exchange gap, leading to capital flight and demonetization of the economy. The populist regime tries to control the budget crisis by re-examining the amount of subsidies and by real depreciation. Economic policies become unstable and real wages fall considerably.

*e) Phase 4*

In this phase, we observe the collapse of the populist government. In the end, real wages decrease to a level significantly lower than that prior to the populist government (see Table 1).

**Table 1** The main properties of phases of populist regime economic life

<b>Stages/main indicators</b>	<b>Unemployment</b>	<b>Inflation</b>	<b>Imports</b>	<b>Subsidies</b>
<b>Phase 1</b>	Decreasing (-)	Constant or decreasing (-)	Increasing (+)	Increasing (+)
<b>Phase 2</b>	Increasing (+)	Increasing(+)	?	Increasing (+)
<b>Phase 3</b>	Increasing (+)	Increasing (+)	?	Constant or decreasing (-)
<b>Phase 4</b>	Increasing (+)	Constant or increasing (+)	Decreasing (-) or constant	Decreasing (-)

Source: Extracted from D&E (1990)

### **3. From Khatami to Ahmadinejad**

#### **3.1. Initial Conditions (1997-2004)**

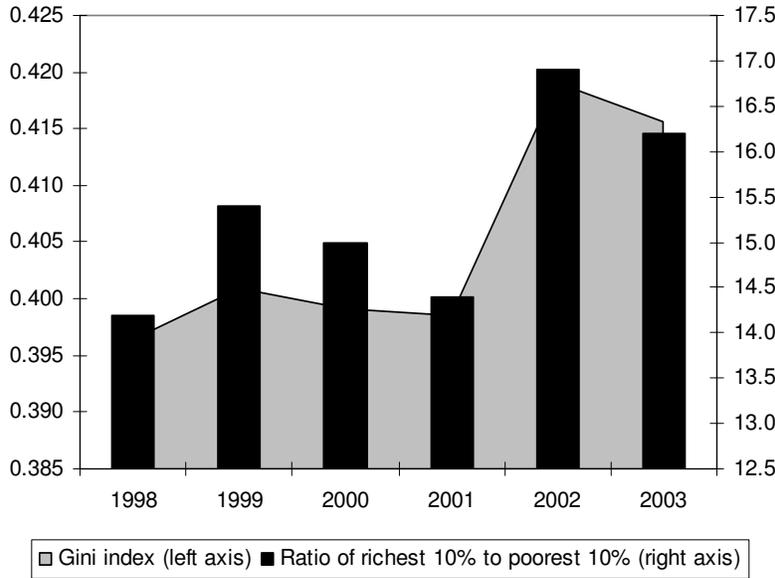
A set of initial conditions is necessary to bring a regime to populism. In this section, I explain the conditions that allowed Ahmadinejad to be successful with his populist agenda. Through eight years of reformist government, the people of Iran and especially the lower classes of society were unhappy with the inability of the state to meet their basic needs.

a) A high degree of inequality was not acceptable for the people in a country rich in oil reserves. The official data confirm people's feelings about their economic situation during the reformist government. The Gini index<sup>2</sup> in urban areas increased from 0.396 in 1998 to 0.415 in 2003/04 (Figure 1). In fact, Iranians have hardly experienced a Gini index lower than 0.39 since the revolution, indicating the inability of governments since that period to use the huge oil revenues at their disposal<sup>3</sup> to establish a welfare state for the people.<sup>3</sup> The

<sup>2</sup> This Index measures inequality of distribution of income. It is a number between 0 and 1, where 0 indicates perfect equality and 1 refers to perfect inequality.

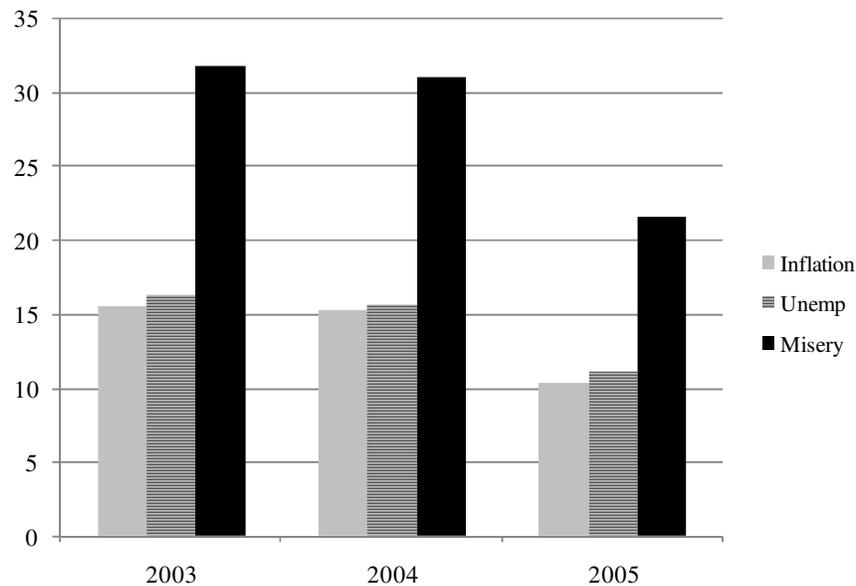
<sup>3</sup> Based on available data the Gini index of Iran in 1998 was 44.1 compared to 24.7, 36.42, 28.65 in Denmark, Jordan, and Pakistan in the same year and to 29.1, 32.9, 32.5, 34.42, 28.31, 40.03, and 25 in Austria, Belgium, Canada, Egypt, Germany, Turkey, and Sweden in the year 2000 (World Bank, 2008).

income distribution inequality index in urban areas illustrates a considerable increase between the richest 10% of households and the poorest 10% in the country during the reformist state. While the ratio of richest to poorest 10% of the population was at 13.9 times in 1998, this ratio increased to about 17 times in 2002 and 16 times in 2003, confirming the failure of reformists to decrease income distribution inequalities (Figure 1).



**Fig.1.** Initial condition for populist state: growth of inequality.  
Source: CBI (2008).

b) The Misery index makes clearer the situation of the social-economic environment of Iran before the populist regime of Ahmadinejad. This index is the sum of unemployment and inflation rates. It is assumed that both a higher rate of inflation and unemployment create economic and social costs for a country. A combination of rising inflation and more people out of work implies deterioration in economic performance and a rise in Misery index.



**Fig.2.** Initial condition for populist state: growth of Misery index.

The Misery index was over 30% in the last two years of Khatami presidency. In the first year of Ahmadinejad government, as predicted by D&E (1990), this index reduced significantly to just above 20% (Figure 2).<sup>4</sup>

c) Another evidence of weak performance of the reformist government can be observed in the GRICS<sup>5</sup> index which was produced by the World Bank. The “*Voice and Accountability Index*” which shows the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media fell from -1.08 in 1996 to -1.36 in 2004, referring to a decline in the freedom of speech in this period in spite of the reformist agenda on political development. Political stability also showed a diminishing trend. The index fell from -0.37 in 1996 to -0.91 in 2004. “*Government Effectiveness*” which measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies fell from -0.30 in 1996 to -0.66 in 2004. The index of “*Rule of Law*” which measures the extent to which agents have

<sup>4</sup> Unemployment data from [http://www.indexmundi.com/iran/unemployment\\_rate.html](http://www.indexmundi.com/iran/unemployment_rate.html) and inflation from [http://www.indexmundi.com/iran/inflation\\_rate\\_\(consumer\\_prices\).html](http://www.indexmundi.com/iran/inflation_rate_(consumer_prices).html) (Access: 13.03.2009)

<sup>5</sup> The Governance Research Indicator Country Snapshot is accessible through the Governance & Anti Corruption section of the World Bank website. The range of these indicators is from +2.5 to -2.5. The former figure indicates the best and the latter the worst situation section under study.

confidence in and abide by the rules of society was also disappointing during this period, falling from -0.77 in 1996 to -0.83 at the end of the reformist government. Just two indicators showed a slight improvement: “*Regulatory Quality*” and “*Control of Corruption*”. In general, most indicators of governance over this period point to a negative performance on the part of the reformist governance in Iran.

The initial necessary conditions were present for the emergence of populism. The increasing inflation during the second term of Khatami reduced the purchase power of public. CPI inflation increased from 11.27% in 2001 to 14.76% in 2004, while inflation based on GDP deflators reached from 11.63% to 21% in the same period. Furthermore, the GDP growth rate had fallen from 7.5% in 2002 to 4% in 2005 (World Bank, 2008).

Ehteshami and Zweiri (2007, p.xvi) illustrate the disappointment of those who elected Khatami:

*“However, it was more surprising to see those who had so wholly bought into Khatami’s reforms so downhearted and disappointed by the end of his first term in office. Though they voted him in again, they nonetheless started blaming him more openly for not achieving his stated objectives, which he had repeatedly promised he would do”.*

Khatami’s first priority was political development. Thus less attention paid by his government to economic issues. This negligence was his Achill Hills. Neoconservatives focused on this weak point of Khatami government among public, mainly needy classes of the Iranian society. Political development slogans in a society which its people struggle for meeting their economic needs were not enough. Ehteshami and Zweiri (2007, p.46) highlighted the outcome of Khatami policies:

*“Ironically, it was the reformists that gave the masses the voice and the tools to articulate their concerns, and it was the movement’s failure to deliver on the tangible needs of the people that left the door open for neoconservative forces to present themselves as a new alternative.”*

The main financial source of populism, oil revenues, was also in a favourable position. In fact, Ahmadinejad could instantly begin his populist programs because oil prices exceeded \$70 per barrel in 2006. The Iranian oil and gas exports increased from 15.74 billion dollars in 1997 to more than 36 billion dollars in 2004 (about 140 % growth).The oil revenues reached a record high in 2005. The actual oil revenues at that time were about 50 billion dollars, 35 % more than the previous year. In 2005, the state received more than 10 billion dollars from the export of non-oil goods, accounting for more than 60 billion dollars of the total foreign exchange

revenues of the country. By comparison, in 1998, the total foreign exchange revenues of oil and non-oil exports amounted to 10 billion dollars.

The two other key issues, namely the balance of payment and international reserves were also affected positively by high oil prices in the year before the election of Ahmadinejad. The considerable increase in foreign exchange revenues (oil and non-oil exports) led to higher levels of imports reaching \$36.6 billion. In addition, the inflow of foreign capital exceeded the outflow of it in 2004 and the capital account showed a surplus of 5.6 billion dollars. Consequently, the balance of payment in 2004 recorded the highest level over its past three years of 9.6 billion dollars.

In spite of all the challenges outlined above through the Khatami government, the Iranian economy was in a good state in terms of foreign reserves when Ahmadinejad was elected as president in June 2005.

### ***3.2. Phase 1: Reactivation and Redistribution Policies***

In 2005/06, the Iranian economy grew by 5.4%, which was 0.6% higher than in 2004/05 and reversed the declining trend of economic growth during the reformist government. The rate of inflation fell to about 10%, 5 per cent lower than the previous year. The Misery index in 2005 compared to its previous year fell by 10% (see Figure 2). Improvement in the balance of payments accelerated, mainly because of rising oil prices, which approached and surpassed \$70 per barrel (averaging about \$51.37 a barrel for Iran in 2005/06). Meanwhile, increasing imports helped to absorb extra domestic demand created by expansionary fiscal and monetary programs of the Ahmadinejad state. In order to implement the first step of the populist agenda, Ahmadinejad began expansionary policies. The rate of growth of all the main monetary indicators increased sharply in 2005/06. The rate of growth of the monetary base which had increased by 17.5% in 2004 shot up to 46.1% in 2005. The growth rate of the money supply (M1) jumped from 16.3% to 25.8%. The increase was more moderate for liquidity, rising from 30.2% to 34.3%, for total deposits, going from 31.4% to 35.8%, and for private sector credit, rising from 37.6% to 38.3%. The financial position of the government was very much affected during the final month of the year as the oil revenues rose 12 times and subsidies quadrupled in that month. In general, current expenditures registered a huge leap of 57.3%, while the increase in total expenditure was 52.5%. Despite the increase in oil prices, the budget deficit was 3% higher than last year.

Despite increasing money supply, inflation was kept under control in the first phase by fixing the prices of governmental goods and services (petroleum products, gas, electricity, water, telephone and postal services) at the level of prices in 2004 as well as by increasing the level of imports. In 2005 and 2006, the first two years of Ahmadinejad presidency, inflation rate reached to 10.4% and 11.9% from 15.3% in the last year of Khatami presidency (2004).<sup>6</sup>

Over the first year of the populist government of Ahmadinejad, the Oil Stabilization Fund (OSF) was transformed into a safe box for financing populist policies. The Ahmadinejad government sent two budget supplements to parliament. These supplements permitted the government to draw \$11.3b from the oil revenues, instead of borrowing from the OSF. The amount of \$3.5b of this figure was used for the import of subsidized gasoline. The rest was directly converted into domestic expenditures, e.g. food subsidy, and government employees' salaries, thus further feeding the populist programs of the state.

Ahmadinejad submitted his 2006-07 budget proposal to parliament on January 15, 2005. The draft of his first budget showed an increase of 27% in total spending compared to the 2005-06 budget, amounting to \$217.4b. The clear point is that his budget heavily relied on oil revenues, projecting the oil prices in his budget plan at about \$40 per barrel, which was the highest price projection throughout the entire Iranian history of budgeting. Real GDP growth was expected at 8%, much higher than what had been achieved in the previous years, showing the aim to boost the economy. The projection of the higher base price of oil per barrel enabled the government to use a larger portion of the country's total oil export revenues and therefore transferring a lower amount of petrodollars into OSF.<sup>7</sup> The direct access to oil revenues enabled Ahmadinejad to expedite his populist programs which mainly focus on current expenditures and short-term projects. The ratio of capital expenditures to current expenditures in his budget plan was 48.7%, while the projection of the Fourth Five Year Economic Plan is about 55%.<sup>8</sup>

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<sup>6</sup> [http://www.indexmundi.com/iran/inflation\\_rate\\_\(consumer\\_prices\).html](http://www.indexmundi.com/iran/inflation_rate_(consumer_prices).html) (Access: 12.03.2009).

<sup>7</sup> The idea of establishing OSF was to save probable extra oil revenues on the basis of oil price projection in budget, using it for productive investment and financing non-oil budget deficits.

<sup>8</sup> Fourth Five-Year Economic, Social and Cultural Development Plan Bill took effect from March 2005.

The support of special interest groups in his budget plan of 2006 was obvious. For instance, some of the budget increases compared to the budget of 2005 showed his commitment to "bringing oil revenues to the dinner tables of special Iranians":<sup>9</sup>

- a) The Services of Islamic Seminaries Organization <sup>10</sup> (*Markaze Khadamate Hozeh Elmieh Qom*), which its directors introduce by the Supreme Leader. The organization provides different kinds of services to clerical students throughout the country: increase of 147.1%.
- b) The Guardian Council <sup>11</sup> (*Shoraye Negahban*), which has a veto power on parliament decisions and is almost under the control of the Supreme Leadership of Iran: increase of 142.2%.
- c) The Representative Office of the Supreme Leader in Universities <sup>12</sup> (*Nahade Namayandegi Rahbari dar Daneshgahha*), which is a conservative body and plays the role of watch dog of the government in universities: increase of 140.8%.
- d) The Islamic Development Office of Islamic Seminaries <sup>13</sup> (*Daftare Tablighate Islami Hozeh Elmieh Qom*), which is active in expanding the Islamic culture and teachings in the country: increase of 110.7%.
- e) The Coordinator Council of Islamic Propaganda <sup>14</sup> (*Shoraye Hamahangie Tablighate Islami*), which is mainly active in organizing the pro-government demonstrations and gatherings: increase of 96.5%.
- f) The Islamic Development Organization <sup>15</sup> (*Sazmane Tablighate Islami*), which official mission is "developing culture of real Islam and manifesting the spiritual life and disseminating the belief and faith values": increase of 95.4%.

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<sup>9</sup> Gooya News Agency Website: <http://news.gooya.com/economy/archives/2006/02/043393print.php> (in Persian, Access: 03.03.2009).

<sup>10</sup> <http://osis.ir>

<sup>11</sup> <http://www.shora-gc.ir>

<sup>12</sup> <http://www.nahad.ir/>

<sup>13</sup> <http://www.ipoh.ir/>

<sup>14</sup> <http://www.fajr.ir/>

<sup>15</sup> <http://www.ido.ir/en/en-default.aspx>

- g) IRIB (Islamic Republic of Iran Broadcasting)<sup>16</sup>, the president of which is appointed every five years by the Supreme Leader: increase of 46%.
- h) The Cleric Elites Secretary Office<sup>17</sup> (*Khobregane Rahbari*), which is a conservative body and evaluates the performance of the Supreme Leader: increase of 44%.
- i) The Supreme Cultural Revolution Council<sup>18</sup> (*Shoraye Enghelabe Farhangi*), which its president is Ahmadinejad: increase of 41.9%.
- j) The Imam Khomeini Education and Research Institute<sup>19</sup>, the president of which – Ayatollah Mesbah Yazdi- is the most famous supporter of Ahmadinejad: the budget of this institute increased 10 times from 3500 million rials (\$360,824) at the end of Kahtami presidency to 35000 million rials (\$3,608,247) in the first year of Ahmadinejad’s governance. This huge increase has continued during the first three years of Ahmadinehad’s governance and reached the 70 billion rials (\$7,216,494) mark in early 2009.<sup>20</sup>

According to Amirreza Khadem, a member of the 7<sup>th</sup> parliament, the average rate of increase in the budget of religious bodies was 100% in the budget of 2006-07. This considerable rise in the budget of interest groups can be compared to the increase in the budget of the Health Organisation (9.4%), the Sport Organization of (4.1%) and the Education Organization (0%). It is interesting to note that the budget under the control of the Islamic Development Organization, which amounted to 190 billion rials is 19 times more than the budget of the Ministry of Health.<sup>21</sup> In sum, the budget of the populist state pays very little regard to financial discipline and relies heavily on oil revenues to reactivate the economy. The expenditure patterns show the aim to distribute the money in exchange for the votes. The two important populist plans of Ahmadinejad upon taking office were “Imam Reza Charity Fund” and “Justice Shares”.

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<sup>16</sup> <http://www.irib.ir/English>

<sup>17</sup> [www.khobreganrahbari.com](http://www.khobreganrahbari.com)

<sup>18</sup> <http://www.iranculture.org>

<sup>19</sup> [http://www.qabas.org/index\\_en.asp](http://www.qabas.org/index_en.asp)

<sup>20</sup> Rooz Online Website, 10.02.2009: [http://www.roozonline.com/archives/2009/02/post\\_11508.php](http://www.roozonline.com/archives/2009/02/post_11508.php) (in Persian, Access: 03.03.2009).

<sup>21</sup> Gooya Agency Website: <http://news.gooya.com/economy/archives/2006/02/043393print.php> (Access: 03.03.2009)

### **3.2.1. Establishing the "Imam Reza Care (or Charity) Fund"**

The first legislation to emerge from his newly formed government was a 12 billion rial (\$1.3b) fund called "*Imam Reza Care Fund*". The initial capital of the fund was financed by a reduction in the National Oil Company (NIOC)'s share of oil revenues.<sup>22</sup> Ahmadinejad's government claimed that this fund would be used to help young people to get jobs and to afford marriage, as well as assist them in purchasing their own homes.<sup>23</sup> According to the initial proposals put forward by the Ahmadinejad government, the fund was introduced through a non-governmental body and it was proposed that 30% could be raised by the Oil Stabilization Fund and the rest by credits in annual budgets, interest-free funds of banks<sup>24</sup>, public assistance, profits of governmental companies, Fund membership payments and repayments of funds.<sup>25</sup>

The major problem of the Fund was the inability of its advocates to find a proper funding for the missions of the Fund. Parliament deputies and economic experts immediately objected to the provision to take 30% of the OSF funds in order to kick-start the project.

After several months of discussions between government and parliament, three different Funds were created: the Employment Assistance Fund, the Rural Development Fund and the Banking Account for Youth Marriage, which came under the collective heading of "Imam Reza Cooperative, Employment and Marriage Fund".

### **3.2.2. Distribution of governmental companies' shares to needy people (Justice Shares)**

The second populist program which was intensely publicized by the Ahmadinejad government and broadly advertised on national TV channels was the "Justice Shares".<sup>26</sup> Under this scheme, the government planned to give the shares of privatized firms at subsidized prices to low-income households. Following this plan, in July 2006, Khamenei - the Supreme Leader

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<sup>22</sup> Baztab News Agency Website: [www.baztab.com/news/28471.php](http://www.baztab.com/news/28471.php) (in Persian, Access: 02.03.2009).

<sup>23</sup> Baztab, Ibid.

<sup>24</sup> Interest-free lending or Gharz-al-hasanah is a common practice in Islamic Banking.

<sup>25</sup> Mehr News Agency Website: [www.mehrnews.com/fa/NewsDetail.aspx?NewsID=312770](http://www.mehrnews.com/fa/NewsDetail.aspx?NewsID=312770) (in Persian, Access: 02.03.2009).

<sup>26</sup> Law and regulation of Justice Shares distribution is available here: <http://www.en.ipo.ir/index.aspx?siteid=83&pageid=305> (in English, Access: 03.03.2009). Distribution procedure can be seen here: <http://www.en.ipo.ir/index.aspx?siteid=83&pageid=299> (Access: 03.03.2009).

- ordered the three branches of government to hand over 80% of the shares of major state-owned firms, including key large industries:

The main idea behind this plan was taken from "voucher privatization" in the former Soviet bloc.<sup>27</sup> The distribution of vouchers that could be exchanged for shares was the dominant privatization method in the Czech Republic, Lithuania, Latvia, Kazakhstan and initially also in Slovakia.

However, Ahmadinejad's plan to distribute wealth among low-income Iranians in exchange for their loyalty has some serious shortcomings:

- a) Because of their inefficient structure and operation as well as poor management, the government compensates for some of the annual losses of governmental companies by giving subsidies. The number of loss making companies increased from 75 in 1997 to 87 in 2006. The amount of loss increased from 1492.2 billion rials (150,327,455 USD) to 43266.4 billion rials (4,359,294,710 USD) for the same period. To offset this loss, the subsidy increased from 531.8 billion rials (53,501,259 USD) to 4150.6 billion rials (418,136,020 USD) for this period.<sup>28</sup> There are some exceptions, especially in oil and gas industry. Of course, the companies in this sector remain under control of state. The maximum reported annual profit for governmental companies has been about 3-4%.<sup>29</sup> Such a profit is negligible in an inflationary economy. Each qualified person receives the total amount of 5 million rials shares (around \$500). Assuming the optimistic situation, the share holders receive 150000 rials or about \$16 per year (taking a fixed profit rate of 3% for each year).
- b) The second criticism refers to the identification of the target groups. According to the plan, the justice shares should be distributed among some 7 million people in its initial phase, including those covered by charity services of the Imam Khomeini Relief Committee and State Welfare Organizations, as well as members of *Basij* (militia of government) and *Sepah* (Revolutionary Guards). The number of recipients will increase to 21 million, during the course of the implementation of project. Usually,

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<sup>27</sup> This is a privatization method where citizens are given or can inexpensively buy a book of vouchers that represent potential shares in any state-owned company. This method was mainly used in the early-to-mid 1990s in the transition economies of Central and Eastern Europe.

<sup>28</sup> <http://www.spac.ir/barnameh/Barnameh%20228/p-2.htm> (in Persian, Access: 12.03.2009).

<sup>29</sup> Deutsche Welle Website: Interview with Mohsen Safaie Farahani, 19 Aug. 2006: <http://www.dw-world.de/dw/article/0,,2408509,00.html> (in Persian, Access: 03.03.2009).

membership of some of these organizations is not subject to real financial problems of householders but depends on their loyalty to the government. Ultimately, well-connected groups benefit from much more attractive shares over this program.

### ***3.3. Phases 2 and 3: Has the Ahmadinejad state surpassed the Second Phase?***

In the second phase, the economy runs into shortages. This is partly due to the increasing shortage of foreign exchange and the price controls. The government introduces protection and reviews the price control system. Inflation increases considerably and wages too. Finally, budget deficits will worsen as a result of the high amount of subsidies

The necessary condition for entering into the second phase is the imbalance between foreign exchange reserves and the populist spending. The distinguishing characteristic of the second phase and the third phase is the subsidy policy (see Table 1). While in the second phase subsidies tend to rise, the government reduces the level of subsidies in the third phase. There is some alarming evidence that the Ahmadinejad government has surpassed the second phase and is in the third phase:

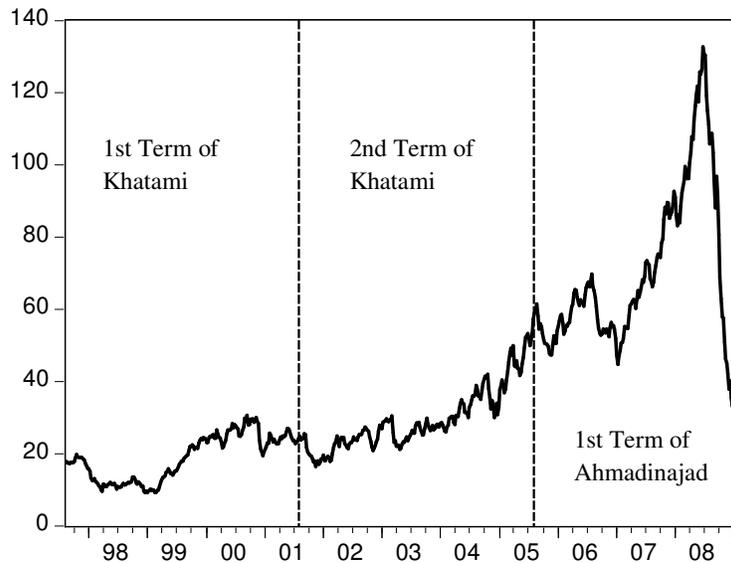
- a) Figure 3 shows the development of the Iranian heavy oil prices during the presidency of Khatami (1997-2005) and Ahmadinejad (since 2005). We observe a significant increase of oil prices from the level of \$20 to \$60 per barrel at the end of the Khatami presidency. Ahmadinejad began his presidency in an attractive oil market situation. Such an increase financed the first phase of his government's populists spending. Ahmadinejad was highly confident of the increasing oil prices<sup>30</sup>, neglecting the warning messages of the Iranian economists about the inflationary effects of his aggressive spending.<sup>31</sup> The first phase ended when the oil market collapsed in September 2008. The oil price reached \$39 a barrel in February 2009. In the face of such a negative oil market in the second half of 2008, the \$307 billion budget has to be

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<sup>30</sup> In July 2008, Ahmadinejad claimed that the price of oil would never fall below \$100 a barrel. See: [http://www.economist.com/world/mideast-africa/displaystory.cfm?story\\_id=12650281](http://www.economist.com/world/mideast-africa/displaystory.cfm?story_id=12650281) (Access: 05.03.2009).

<sup>31</sup> In November 2008, a group of 60 Iranian economists sent a letter to Ahmaedinajd, challenging his populist approach toward economy. In this 30 page letter, economists criticized his policies: "Meager economic growth, increasing unemployment rate, increasing inflation rate, crisis in capital markets, government expansionary budget..., inequality and poverty combined with global crisis have a big impact on exports and imports of the country". Ahmadinejad paid no attention to this letter. See: <http://articles.latimes.com/2008/nov/10/world/fg-iran10> (Access: 05.03.2009).

financed by a deficit. The estimated borrowing amount is between 7-50 billion dollars.<sup>32</sup>



**Fig.3.** Weekly Iran heavy spot price FOB (dollars per barrel).

Source: EIA (<http://www.eia.doe.gov>)

According to the D&E framework, the Ahmaedinejad's government entered into his second phase. In the second phase, the populist government resists a reduction or any reform of subsidies. The massive subsidies on fuel products continued during most of 2008. The government spent 13.6 million rials (\$1380) per person in 2008 as subsidies, mainly for energy.<sup>33</sup> An increasing inflation rate as a common aspect of the second and third phases is evident. The Ahmadinejad government initially managed to lower inflation in its first phase of state. However, the inflation rate increased significantly in 2007, reaching 18.4%.<sup>34</sup>

- b) In the third phase, the financial pressures due to shortage of foreign exchange reserves (e.g. mainly due to a fall in oil prices) force the populist government to undertake fundamental revisions in its aggressive spending. In January 2009, Ahmadinajd presented the budget to the parliament. This budget totalled 2827000 billion rials

<sup>32</sup> <http://www.wsws.org/articles/2008/oct2008/iran-o29.shtml> (Access: 05.03.09)

<sup>33</sup> Based on another source, in 2008, the government paid \$100 billion direct and indirect subsidies for goods.

<sup>34</sup> <http://www.spac.ir/barnameh/306/p7.htm> (in Persian, Access:12.03.2009)

(\$287 billion). In a rare example of Iranian budget history, the 2009 budget fell by 2.5% compared to its previous year's actual budget. Ahmadinejad who used to ignore the warnings from economist during his first and second phases of state, admitted the crisis symptoms in December 2008. He said that the government would have to abandon "a major part" of its public projects.<sup>35</sup> Apart from suspending these projects, the populist government had to revise its hardly manageable subsidy plans. In December 2008, Ahmadinejad presented a plan to parliament proposing an end to fuel, water, and electricity subsidies. "Falling oil prices encourages us to promptly implement the bill; *it is time we made a decision*", Ahmadinejad told the parliament as he defended the removal of subsidies.<sup>36</sup>

The evidence implies that Ahmadinejad populist governance is in its third phase of life. The fourth phase would mean his removal from office. Whether this will happen will be cleared in the next presidential election in June 12, 2009.

#### **4. Conclusion**

I have examined the political life process of the Ahmadinejad's government on the basis of the D&E analytical framework which is designed for populist regimes. This framework has four phases. The D&E model points out that most populist regimes have a promising start: the inflation and unemployment rate are reduced, while subsidies increase. This is what Iranians experienced during the first two years of the Ahmadinejad's government. By entering into the second phase, there are not enough foreign exchange reserves because of the reduction of oil revenues. Consequently, the inflation rate which was controlled by regulated prices and by increasing imports can no longer be maintained. In this phase, there are increasing pressures on the populist state to reform the subsidy system. However, this reform is costly and the populist government is afraid of losing support. The third phase of a populist regime has much in common with the second phase except for position of populist state against heavy subsidies. The high imbalance between the financial sources of populist regime and its spending in the third phase will make a reduction or halting of subsidies unavoidable. The

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<sup>35</sup> [http://online.wsj.com/article/SB122973669825423389.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB122973669825423389.html?mod=googlenews_wsj) (Access: 04.03.2009).

<sup>36</sup> <http://www.iht.com/articles/ap/2008/12/30/news/ML-Iran-Subsidies.php> (Access: 04.03.2009). In May 2007, the government had started to implement a rationing system for gasoline consumption. However, there was never a direct statement about ending the energy subsidies as mentioned by Ahmadinejad one year later in 2008.

Iranian economy in 2008 and 2009 reflects the third phase of the populist state. The fourth phase may be realized in the coming presidency election in June 2009.

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