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Supporting Iran in implementation of an integrated energy efficiency market

The new Iranian government and its economic implications

The New Government

In June 2021 Ebrahim Raisi was elected as Iran's new president, succeeding Hassan Rouhani. The election was held in economically difficult and challenging times affected by the COVID-19 pandemic, persistent economic structural rigidities and continued Western and especially US sanctions. Economic distress and the pandemic also contributed to a historically low election turnout out of 49%: the lowest turnout in any Iranian election so far [1,2]

Prior to his election, Raisi presented his roadmap for the economy with seven priorities. For a stabilisation of the economy, the most important points are growth in exports, a financial sector reform and a fiscal reform.

While concrete policies for achieving these strategic goals still need to be developed and implemented, it is already clear that foreign policy will play a particularly important role, especially to increase exports and foreign direct investment.

Active Economic Diplomacy

President Raisi is considered a hardline conservative figure in Iran and is also known as a critic of the West, in particular the United States. Nevertheless, he plans to remove the US-sanctions through *active economic diplomacy,* without specifying which diplomatic measures will be proposed to convince the US to remove the sanctions.

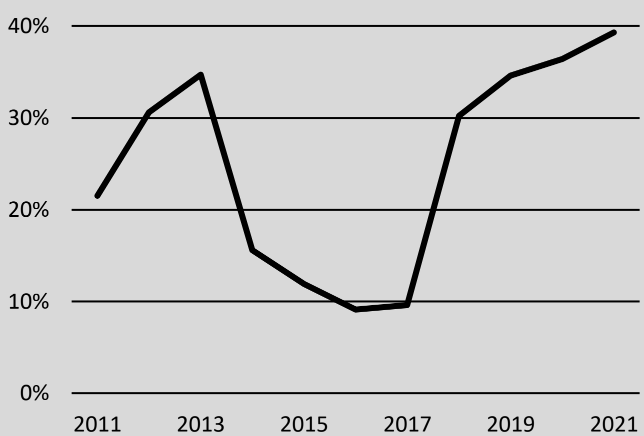
Recently, Iranian foreign policy was more focused on reducing the effects of the US sanctions rather than removing them. The Iran-China 25-Year Cooperation Program[3] signed in March 2021 and Iran joining the Shanghai Cooperation Organization[4] will both strengthen economic cooperation with China. Thus, Iran expects increasing investments from and expanding trade with China, thereby reducing the impact of the US sanctions.

In the attempt to re-start the negotiations on the nuclear deal with Iran (JCPOA), both China and Russia may serve as counterweights to the USA. The Iranian side is disappointed by the JCPOA agreement's failure to normalize Irans trade relations with the world and by the unilateral withdrawal of the USA.[5] Hence, the Iranian government does not intend to return to the previous agreement and calls for the US to release 10 billion USD in blocked assets as a prerequisite for new serious talks.

Economic Policy

These foreign policy challenges are linked to the core problems of the Iranian economy: the lack of macroeconomic stability and the chronically huge budget deficit. For the current fiscal year the estimate is that just 40% of the central governmental expenses are covered by revenues of the government.[6] The main reason is the heavy reliance on revenues from fossil fuel exports, which are mostly blocked because of the US sanctions. Instead, the budget deficit is financed by the central bank through increased money supply and thereby high inflation of almost 40% (see figure 1).

Figure 1. Average annual change in consumer prices in Iran



Source: IMF

To reduce the budget deficit, the new Iranian government indicated plans to reduce subsidies on electricity, gasoline and other products. At the same time, an increase in direct handouts for people in need is in discussion, possibly by “quasi cash” subsidies, i.e. transfers that can only be spent on certain goods and services. A socially just design of reforms is important to increase acceptance among the population, especially in challenging times for private households with high inflation rates and the pandemic.

The burden of stabilizing the governmental budget should thus be fairly distributed. Besides the improvement of taxpayer compliance, the elimination of tax exemptions for foundations and other exempt entities should be considered. The urgency of such reforms is demonstrated by the low tax to GDP ratio in Iran of about 6.8%. This rate is among the lowest in the world and cannot be justified simply with economic peculiarities of Iran. Most developing countries achieve significantly higher tax rates. For example, the respective tax to GDP ratios in Russia, Kazakhstan or Azerbaijan are 26.4%, 16.9% and 13.1%. [7]

Discussion

Now, with Raisi’s presidency all three branches of the Iranian government — executive, legislative, and judiciary — are politically aligned and controlled by hardline conservatives. This will take away any opportunity to blame others in Iran for the economic failure. President Raisi’s economic plan so far alludes to different angles of addressing Iran’s core economic problem – the growing budget deficit and resulting high inflation.

First, the government deficit could be partly financed by issuing government bonds. However, the government will need to pay a hefty risk premium, if domestic capital markets are to absorb such large government bond issues. According to the March 2021 budget plan, government bonds account for 15 % of government revenues.[8]

Second, President Raisi aims to increase taxes on speculative activities on the stock market, while reducing taxation for manufacturing firms. In the absence of an efficient infrastructure for collecting Tobin-style taxes on speculative transactions, this proposed tax reform will most likely not significantly increase government revenues. A focus on enforcing existing taxes and reducing exemptions is more promising. Additionally, the business climate should be improved and the role of the private sector should be broadened.

Third, while the government’s plans of reducing energy subsidies are a step in the right direction, the effect on the budget deficit is questionable if the subsidy reform is accompanied by further unsustainable expenditures in other fields. In addition, the need for increased expenditures for a successful vaccination campaign to fight the COVID-19 pandemic and for improving Iran’s infrastructure add further pressure on the budget deficit.

Fourth, the budget deficit could be reduced by increasing export revenues, particularly from oil exports. A new nuclear deal which would remove the US sanctions would be a crucial step for raising exports.

An improved environment for energy exports could also provide an important stimulus for the M3E. If participants in the M3E were able to sell their saved energy at export prices, they would have a stronger incentive to become more energy efficient. Increased energy efficiency would in turn reduce households’ dependence on governmental subsidies and thus reduce the burden of energy costs when energy prices increase as subsidies are eliminated.

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Footnotes

1. Khamenei protege wins Iran election amid low turnout | Reuters
2. Economic Distress and Voter Turnout in the Iranian Election | Friedrich Ebert Stiftung
3. Among other goals, this program is supposed to direct chinese investments towards Iran and to integrate Iran into the Silk Road Economic Belt Initiative. Full text of Joint Statement on Comprehensive Strategic Partnership between I.R. Iran, P.R. China (president.ir)
4. The complete acceptance could take up to two years to finalize. The goal of the organisation is to promote a closer cooperation in political, economic and security issues between its members. Particularly, Russia and China are of great importance for Iran´s foreign policy. Shanghai Cooperation Organisation (sectsco.org), Iran Turns to Russia and China in Face of U.S. Sanctions (foreignpolicy.com)
5. Iran Deal Negotiations: What the Raisi Administration Wants From JCPOA Talks (foreignpolicy.com)
6. Raisi’s Roadmap for the Economy: More than a Fata Morgana? (fes.de)
7. https://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78
8. Raisi’s proposed economic policy plan for Iran doesn’t make sense - Atlantic Council