

## U.S. Sanctions on Iran:

### What Has Been Achieved and at What Cost?

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Jun 3, 1998

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#### Articles & Testimony

**T**estimony before the House Committee on International Relations

The U.S. sanctions on Iran have imposed costs on the U.S. economy, but those have been small compared to the benefits.

When the sanctions were adopted, the weight of expert opinion was that they would have little effect on Iran. The Financial Times headline was, "Iran sanctions won't work."<sup>1</sup> But they have hurt Iran, as is now widely acknowledged. For instance, the respected Middle East Economic Digest, which had pooh-poohed the sanctions when they were imposed, concluded, "Sanctions are succeeding in holding back Iran's oil field development programme."<sup>2</sup>

The impact of sanctions has been magnified first by Iran's inappropriate economic policies and more recently by sheer luck. Because of poor management, Iran had run into a foreign debt crisis in 1993/94, just as the United States began to apply economic pressure against Tehran. Realizing it was vulnerable to U.S. pressure on its lenders, Iran in 1993/4 stopped borrowing from abroad and instead has devoted between \$3 billion a \$4 billion a year to paying principal on its debt, besides paying interest.<sup>3</sup> The change from a net borrower to a net repayer was a \$9 billion a year swing, and that meant imports had to be cut from \$23 billion in 1992/93 to \$13 billion a year in 1994/95 and 1996/97. Iran's economy was suffering, which made the U.S. pressure all the more powerful. By 1997, Iran had largely resolved its foreign debt problem and looked ready to resume more normal economic growth. That would have made Iran less concerned about the U.S. economic sanctions. But then oil prices dropped: Iran's net oil exports in 1998 may be \$10 billion compared to \$16 billion in 1996. With oil prices so low, Iran is once again worried about every penny, and therefore the U.S. economic pressure is felt more keenly. In short, the United States government has cleverly positioned itself to take credit for Iran's economic problems, when those problems were mostly caused by other factors. Because of low oil prices, Iran is particularly vulnerable to continued U.S. economic pressure.

Benefits of the Sanctions Sanctions have had two major benefits from the perspective of U.S. interests. The first and most important has been on Iran's domestic political scene. Iran's economic problems have been an important factor in the widespread popular dissatisfaction with rule by the politicized clergy (which, it should be emphasized, are only a small part of the clergy as a whole and do not include those most respected for their piety). Living

standards are now no more than half the pre-revolution level. And the future looks bleak. Without U.S. technology and without funding from international capital markets, Iran will be hard pressed to increase oil output. Oil income will be stagnant while population is growing quickly. The post-revolution baby boom, encouraged by conservative mullahs, is now graduating high school and looking for work. Iran has only been able to create 350,000 jobs a year for the 800,000 young men joining the labor force each year (setting aside the employment aspirations of Iran's young women). In other words, Iran will badly need the foreign capital that U.S. containment impedes.

There are certainly those in Iran who realize that the country's economic prospects are poor unless it is able to raise large amounts of foreign capital and that the only way to do so is to improve relations with the West. That has been an element in the support for President Khatemi. We cannot know exactly how important for Khatemi's victory was the sanctions-induced economic pain. Probably it was a rather small factor; domestic issues predominated in that contest, as in nearly all elections. Still, the sanctions had some positive impact, and perhaps that is about all the U.S. government can achieve.

In addition to their impact on the Iranian political scene, sanctions have made an important contribution to U.S. security by depriving Iran of the resources it could otherwise have used for a military buildup. Iran had to curtail its 1989 five year plan for \$10 billion in weapons purchase because of budget problems -- problems due in significant part to the U.S. pressure against loans to Iran which began in 1993. In the period 1989-96, Iran announced agreements with various suppliers to purchase many more weapons than it actually acquired, e.g., 1,000-1,500 tanks agreed to but only 184 acquired; 100-200 aircraft agreed to but only 57 acquired, and 200-300 artillery pieces agreed to but only 106 acquired.<sup>4</sup>

The reason for the shortfall was generally lack of money. Tehran reported to the IMF that its total military expenditures, including operating costs as well as weapons purchases, were only \$1.3 billion a year on average in 1991/2-1994/5, compared to the planned \$2 billion a year just for weapons purchases.<sup>5</sup> That shortfall in Iranian arms spending has had a significant impact on the balance of power in the Gulf. With an extra one billion to two billion dollars a year, Iran would have been able to add more weapons with which to threaten stability in the Strait of Hormuz. For instance, Chinese officials relate privately that the reason China stopped deliveries of advanced anti-ship missiles to Iran was that Tehran was behind in payments by most of a billion dollars. Note that in this case, the United States was better able to achieve its goal (stopping missile sales) via economic pressure on Iran than via inducements to Iran's suppliers (specifically, offering China better access to U.S. nuclear power technology).

Had the U.S. not gone down the route of sanctions to contain Iran, then the U.S. would have needed to implement other policies to respond to what would be a larger Iranian military -- larger because an unsanctioned Iran would have more access to international capital and therefore been able to afford more weaponry. The usual estimate of the cost of present U.S. military preparedness in the Persian Gulf, against both Iran and Iraq, is \$50 billion a year. A greater Iranian threat would require an increase in that amount. For instance, a larger and more modern Iranian navy would require more antisubmarine and antimine ships and aircraft; more Iranian missiles would require a larger theater missile defense network; more Iranian fighter and attack planes would require the presence of more U.S. planes, probably including more frequent visits by aircraft carriers; and there would have to be a general increase in reconnaissance and intelligence assets. Plus there would have to be a variety of equipment and personnel held in reserve earmarked for a conflict involving Iran. These items could have added at least 10 percent to the approximately \$50 billion the U.S. spends for defense of the Gulf -- in other words, the alternative to sanctions would have been \$5 billion a year added to the Pentagon budget. That is a hefty cost which more than counterbalances the costs Iran sanctions have imposed on the U.S. economy.

Costs of the Sanctions As with nearly every foreign policy objective, the sanctions on Iran have imposed costs on the United States. Those costs fall into two large categories: the economic costs and the complications for other policy

objectives.

**Economic Costs of the Sanctions** The direct financial costs to the U.S. economy of the sanctions on Iran were a loss of profits on trade and investment. The largest direct loss was on about \$3 billion in oil trade involving Iranian crude destined for third country markets and the proposed Conoco development of the offshore Sirri oil field. Less important was a reduction in U.S. exports. Such exports had not been large; in 1993, U.S. exports to Iran were \$616 million. And it appears that sales continue through re-exports from Dubai in the UAE, which re-exports to Iran a billion dollars a year, perhaps half of which comes originally from the U.S. Indeed, European diplomats complain privately that for many consumer products, U.S. goods continued in 1997 to dominate the Iranian market. The total foregone profits on all types of trade and investment would seem to be on the order of several hundred million dollars a year.

The indirect financial costs are larger. One consideration is the increasing concentration of world oil production in the Gulf Cooperation Council (GCC) states that will result if the sanctions on Iran, Iraq, and Libya are sustained for the medium term. The U.S. interest is in a diversity of oil sources, so as to reduce the risk of overall market disruption were there to be a problem with access to oil from any one country. A policy which restricts development of oil in three major producers at the same time goes against that overall U.S. interests in diversifying oil sources.

A rather different issue is the cost to the U.S. oil industry if it comes to be seen as an unreliable partner for political reasons. While perhaps not dominant as it once was, the United States is obviously a significant player in every aspect of the oil business, from exploration and production technology to investment and trading. The U.S. competitive edge could be dulled by the perception that dealings with the United States are subject to abrupt cutoffs for political reasons. The specific targeting of the petroleum industry -- first in President Clinton's March 1995 executive order and then in the Iran-Libya Sanctions Acts (ILSA) -- are a precedent that troubles the industry.

A related problem is the cost that comes from the politicization of trade. U.S. action against Iran, especially the secondary boycott mandated by ILSA, is an important example of making trade subject to political ties, rather than based on market considerations. Economists prefer to see trade separated from politics, on efficiency grounds. Besides that general consideration, there is a more specific problem for the United States if traders worldwide come to consider the United States as an unreliable and unstable trading partner, because Washington is prone to ban trade for unpredictable political reasons.

**Complications for Other U.S. Policy Objectives** While the economic costs of Iran sanctions have been relatively limited, a more serious problem has been the collateral damage, that is, the complications caused for other U.S. policy objectives. Let us look at the implications area by area, to show that the regional complications -- for policy towards the Caspian Basin states, the GCC, and Iraq -- have been small, but the cost in relations with Europe have been more important.

The sanctions on Iran have complicated the search by Caspian Basin (Central Asian and Caucasian) states for alternative trade routes so as to lessen their dependence on Russia. Iran is well positioned to provide trade routes, including routes for oil and gas pipelines to permit full development of the Caspian Basin oil and gas resources now largely sitting idle because of lack of access to markets. U.S. pressure has impeded the investments necessary for Central Asia to use routes through Iran. Some analysts see that as a major problem for the Central Asian countries, forcing them to rely on Russia. However, Iran places great store on its relation with Russia, with which it proclaims it has a strategic alliance against the West and which is its principal arms supplier. Furthermore, Iran and Russia are both large producers of oil and gas, whose interests are ill served if Caspian Basin oil and gas reach markets that they could themselves serve. Under these circumstances, it is hardly surprising that Iran has cooperated closely with Russia on regional issues, such as establishing peace in Tajikistan.

Some have argued that containing Iran has exacted a price in relations with GCC countries. To be sure, dual containment is not particularly popular in the GCC states. To some extent, the policy has been the victim of its own success: the demonstrated U.S. will and ability to check external aggression has led to complacency about the threat from Iran, as well as Iraq. On the other hand, the GCC governments are generally more aware than is popular opinion that the U.S. presence is what keeps Iran from carrying out aggression. At the same time, the U.S. umbrella over the Gulf has encouraged some GCC governments to explore an opening with Iran, secure in knowing that were there to be a real security threat, the United States would come to their rescue. This is hardly surprising behavior from small states protected from a large nasty neighbor by a distant superpower; indeed, much the same pattern was seen in Europe during the Cold War. Cold strategic calculation, not Arab deviousness, suggests the GCC states may publicly call for reconciliation with Iran while urging the United States to be vigilant against the dangers of its aggression.

Another criticism of the sanctions on Iran has been that it has impeded the containment of Iraq. However, to focus on containing Iraq rather than a dual containment of both Iraq and Iran is impractical. The same forces opposed to the sanctions on Iran are also working to undermine the sanctions on Iraq. For instance, French and Russian officials maintain that the most appropriate policy towards both countries is to replace sanctions with engagement, to offer incentives rather than to contain. Similarly, the arguments from the U.S. business community that sanctions do not work are usually made against all sanctions, and the numerous deals done with Iraq by international oil firms show how powerful is the pull of prospective oil income in Iraq as well as Iran. Were sanctions to be dropped on Iran, even louder calls would be made to end the sanctions that are hurting ordinary people in Iraq. And besides the effects on sanctions, there would be an impact on the Gulf monarchies' policies. If the U.S. changes its loudly proclaimed stand on Iran, those countries will be all the more nervous that the U.S. may one day change its mind about Iraq. That will only feed the natural tendency of the weaker Gulf states to accommodate to their powerful neighbors. Plus there is a widely held view in the GCC states that Iran is the greater long-term threat. If the Gulf monarchies see Iran gaining strength and the U.S. vacillating, their inclination will be to accommodate themselves to Saddam. In short, it is unrealistic to expect that a change in U.S. policy towards Iran would increase the pressure on Iraq. In fact, a weakening of the containment of Iran would work to Saddam's advantage. The only alternatives open for U.S. policy in the Gulf now are dual containment or no containment.

More troubling has been the impact of Iran sanctions on U.S. relations with Europe. The failure to secure broader support for sanctions against Iran has often been interpreted in Washington as a product of European interest in selling to Iran irrespective of that government's misdeeds. In Europe, the usual explanations for the differences across the Atlantic on Iran policy are, first, that Washington's exaggerated hostility to Iran is based on domestic politics rather than strategic interests, and, second, that engaging Iran and encouraging Iranian moderates will be the more effective route to change unacceptable Iranian behavior.

The most controversial issue in the sanctions strategy has been ILSA. Europeans complain that the secondary boycott provisions of ILSA -- which they regard as the extraterritorial application of U.S. law -- is unacceptable in principle, irrespective of the purpose to which it is put. In the U.S. view, ILSA is marginally extraterritorial since it applies only to those wishing to sell in the United States market, and this kind of extraterritoriality is not unusual.<sup>6</sup> European Union (EU) governments also argue that ILSA-style measures are contrary to the provisions of the World Trade Organization (WTO).

The dispute over Iran policy has been fed European anger at what is seen as U.S. bullying. ILSA, combined with the Helms-Burton Act and non-economic issues like the vetoing of a second term for U.N. Secretary-General Boutros Boutros-Ghali, have been seen as evidence that the United States insists on dictating to Europe on those issues where the two disagree. The perception of unfair U.S. pressure has hurt the overall relationship, which is arguably the most important foreign tie the United States has, and have impeded agreement on the specific issues of

disagreement.

Washington hoped that ILSA would provide a basis for negotiations with Europe about measures against Iranian terrorism and WMD. Such measures could provide the means to grant EU countries a general waiver of ILSA, under its Section 4c. When this issue was raised with the EU at an April 11, 1997 meeting, the immediate EU reaction was that the United States had caved on ILSA, leading the United States to clarify to EU embassies that was not at all the U.S. interpretation of what was discussed. Since then, the EU countries have been generally unwilling to negotiate under pressure from ILSA.

The French government has been particularly uninterested in reaching agreement on how to respond to problems with Iran. In September 1997, when the French firm Total announced a two billion dollar deal with Iran to develop the South Pars gas field, in partnership with Gazprom of Russia and of Malaysia, Total went out of its way to spit in the eye of the United States. Its chairman Thierry Desmarest proclaimed, "Under any hypothesis, they [U.S. sanctions] would have only very minor consequences for Total. Our U.S. presence is very small [accounting for 3-4 percent of the group's FF180 billion annual sales]. It is more important for an oil company to be in the Middle East than the U.S."<sup>7</sup>

The United States recently clarified a change in policy that had been forming since October 1997, namely, the retreat from the threat of a secondary boycott over the South Pars deal. This decision had little to do with Iran: it was overwhelmingly a product of European pressure. A secondary factor was the U.S. business community's lobbying against sanctions as a whole, which served to reduce Congressional willingness to take a strong stand on Iran sanctions. A third factor, definitely less than the other two, was the perception that Iran may be changing, and therefore some gesture should be made to President Khatemi.

The Clinton administration has handled poorly its reaction to the Total deal. The deal was a poor case for the United States to push hard on -- Total sold most of its U.S. assets three days before announcing the deal, and the French government could gain on the domestic political scene by standing up to U.S. pressure. ILSA was crafted to provide great flexibility for such cases, but the Clinton administration did not make use of the act's possibilities. For instance, the U.S. government could have quickly applied to Total limited sanctions. The law requires choosing two of six specific measures, and two of them -- denial of credits from the Export-Import Bank and refusal of permission to be a primary dealer in U.S. government securities -- are entirely outside the domain of the WTO. Had Washington applied such sanctions against Total, France would have had no basis for a WTO complaint. And Washington could have sustained the deterrent effect of ILSA by darkly hinting that it would react more severely against other firms more vulnerable than Total.

It could be argued that a general waiver of ILSA was in the U.S. interest, because the strong EU reaction showed that ILSA does not work or that its cost is too high. If so, the time to proclaim such a waiver would have been just after Khatemi's inaugural in August 1997, the month before the Total deal was announced. Had that been done, the waiver could have been presented as a U.S. olive branch to the new government, which would have put the ball in Iran's court to respond.

By waiting instead to waive ILSA, the Clinton administration has given the impression that it will not stand up to Iran despite the past strong words, which could create problems for the credibility of U.S. policy globally. The risk is that a rogue government may decide that it can ignore strong declarations from Washington, on the grounds that similar statements about Iran led to no action. At some point, the United States may find that a rogue, who could have been deterred had Washington's word not been doubted, engages in aggression that must be reversed by use of force.

Next Steps Sanctions are part of a policy to pressure Iran, not to isolate it. Indeed, U.S. interests are well served by more contact with Iranians at all levels. An important initiative in this domain is the Radio Free Europe/Radio

Liberty broadcasts to Iran, which can crack the monopoly of electronic news in Iran. Radio Free Iran will show Iranians that the United States supports the sort of free debate already present in Iran's low-circulation print press, which strongly contrasts with the strictly controlled and viciously anti-Western radio and television.

The long-standing U.S. position is that it is open to a dialogue with official Iranian government representatives, though not with self-styled intermediaries. While the U.S. might not have been eager for such an official dialogue in times past, Washington would certainly be interested in talking with the Khatemi government. Khatemi has shown some signs that he may modify Iran's stance towards the United States. However, along with his nice-sounding words, Khatemi has showed no signs of a change in position on the key issues of concern to the United States, namely, WMD, terrorism, and the peace process. He has also repeatedly rejected official dialogue with the United States, though it is interesting to note that technical meetings of various sorts attended by both U.S. and Iranian representatives have become more common.

If an official dialogue between Washington and Tehran were to begin, that could be combined with continued sanctions. Deterrence and detente can go hand in hand, as was done with the Soviet Union for decades. Consider that the United States has had intense and high-level dialogue with Castro's Cuba for 20 years, while during that time, U.S. sanctions on Cuba have grown tougher. At the same time, the United States should be prepared to ease or lift sanctions if Iran demonstrates that it has changed the behavior that led to the imposition of sanctions. For instance, if Iran were prepared to abandon its nuclear power program -- a program that provides an opportunity to advance Iran's nuclear weapons ambitions -- the United States could lift its objections to World Bank lending for Iran's electricity generating needs and could encourage Japan to restart disbursement of its blocked 121 billion yen loan for a hydroelectric dam.

More immediate than the question of government-to-government dialogue is the issue of how to respond to the current vigorous factional struggle in Iran. Some suggest that the United States needs to find a way to support Khatemi. That miscasts the issue. The United States needs to support the 20 million Iranians who voted for change, not to support one problematic individual. Khatemi is not deserving of U.S. support: he is no friend of the United States. He was allowed to run for president at a time when 234 other candidates were disqualified, because the clerical elite were sure he is a man of the system, whose goal is to make the Islamic Republic stronger by reforming those aspects that have caused it to lose popular support. In his CNN interview, Khatemi denounced the "flawed policy of domination" followed by the U.S. "over the past half century" for "dash[ing] the hopes of the people of the colonized world" as well as "inflict[ing] damages upon" Iran. He has also repeatedly rejected official dialogue with the United States, though it is interesting to note that technical meetings of various sorts attended by both U.S. and Iranian representatives have become more common.

If the issue is correctly cast as how to achieve change in Iran (rather than how to help Khatemi), then it is quite possible that the most productive approach would be continued pressure. Such pressure would show Iran's leaders why change is needed. The pressure could reinforce the momentum towards change by showing that the United States will remain consistent in applying the firm standards it has set by which to judge Iranian behavior. If on other hand the U.S. government were to reward Iran for merely holding a government-to-government dialogue, then Iran could think that talk alone is all it needs to do. At the same time, the United States might consider using modifications of the sanctions policy as a means to signal the Iranian people about the U.S. desire for better relations if only the Iranian government would modify its behavior. For instance, the ban on U.S. exports of consumer goods could be lifted -- it serves U.S. interests when Iran uses its scarce foreign exchange for consumer goods rather than weapons, plus U.S. firms could benefit from the sales.

What then is the final evaluation of sanctions? At the least, it has raised the cost to Iran in its relations with the West of pursuing WMD, terrorism, and peace process obstruction. By making other Western countries more sensitive to

Iran's actions, sanctions have reduced Iran's access to dual-use technology needed for WMD and have reduced the freedom with which Iranian agents operate in Western countries. The race is between how long the West can postpone Iran's ability to obtain WMD and how quickly Iran will change its policies (through triumph of less extreme elements or through end of clerical rule, either of which will come primarily for domestic reasons). On the down side, sanctions have raised tensions in the all-important U.S. relationship with Europe. The challenge is how to increase the price Iran must pay for its unacceptable behavior while reducing differences with Europe over how to proceed.

Notes:

1 Financial Times, June 12, 1995.

2 David Butter, "Economic Recovery Puts Down Roots," Middle East Economic Digest, January 3, 1997, p. 5. Geoffrey Kemp, who recently visited Iran, has written, "the sanctions do have an impact on the Iranian energy sector.. Iran is anxious to get out from under U.S. sanctions in order to develop its vast energy sector" ("How Iran Has Changed," Newsweek, April 27, 1998, p. 50).

3 All economic data (except projections) come from International Monetary Fund, "Islamic Republic of Iran - Statistical Appendix," IMF Staff Country Report No. 96/108, October 1996.

4 Michael Eisenstadt, Iranian Military Power (Washington: The Washington Institute for Near East Policy), pp. 36-7.

5 U.S. government estimates show a similar trend. To quote Bruce Riedel, National Security Council Senior Director for Near East and South Asian Affairs, "Foreign exchange expenditures on arms have dropped from a high of \$2.5 billion in 1991 to less than one billion dollars last year" ("U.S. Policy in the Gulf: Five Years of Dual Containment," speech to The Washington Institute for Near East Policy Soref Symposium, May 6, 1998).

6 As noted in the Wall Street Journal editorial of October 6, 1997, "France doesn't let foreign firms do as they will in France either, if their activities are in some way contrary to French law or policy. In fact, a lot of laws all over the globe are extraterritorial" (p. A22).

7 Financial Times, September 30, 1997, p. 9.

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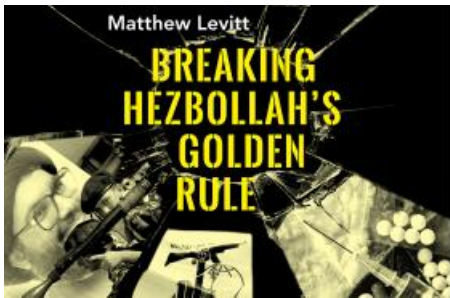
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