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Iran's New Budget Is Tight, But Not Tight Enough

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Brief Analysis

Rouhani has taken a remarkably austere fiscal approach ahead of the looming parliamentary election, but the country's economic situation is still not sustainable over the long run.

On December 8, following established procedures, President Hassan Rouhani visited parliament to present his budget for the Iranian year 2020/21, which begins in March. Notwithstanding the government's rosy rhetoric, his spending proposals show the tough times the Islamic Republic is facing.

NOT A POPULIST BUDGET

The February 21 parliamentary election is rapidly approaching, so one might have expected Rouhani's budget speech to unofficially kick off the height of the campaign season. Indeed, past presidents have often stuffed voter-pleasing provisions into budgets just before elections. Yet Rouhani has done nothing of the sort.

For instance, he proposes government spending of 4.8 quadrillion rials, in addition to 0.8 quadrillion rials in dedicated revenues and another 14.8 quadrillion rials in spending by state-owned enterprises. (Translating these figures into dollars is murky: the official exchange rate is 42,000 rials per dollar, but the free market rate is about 130,000.) This combined spending will increase 8% compared to this year, yet inflation is at least three times as high, and no tax relief will be issued.

Moreover, Rouhani proposes maintaining the newly introduced monthly cash payments to the poor at less than $4 per person at the official exchange rate, or about $1 at the free market rate. And while government salaries will increase by 15%—which in the Iranian system translates to a similar increase in nearly all other salaries—this figure is well below the likely inflation rate, similar to what happened with last year's 20% salary increase. Indeed, inflation-adjusted salaries in 2020/21 may well drop one-third compared to the beginning of this year, a fact that will not help his camp win votes in February.

CONTINUING POOR POLICIES

On the whole, Rouhani's macroeconomic policies have been as bad or worse than those of his predecessor, Mahmoud Ahmadinejad. Faced with a sharp drop in oil revenues due to U.S. sanctions, Ahmadinejad mobilized money for the government by letting the rial depreciate, which raised the number of rials Tehran received for each dollar of oil sold. The larger number of rials per dollar also encouraged exports and stimulated local production to replace imports—both desirable outcomes given that Iran was earning fewer dollars from oil. Yet Rouhani has stubbornly resisted a similar adjustment of the rial.

Keeping the official exchange rate constant while using reserves and administrative pressure to moderate the rise in the free market rate makes no sense. One does not need a doctorate in economics to realize that when Iran's inflation rate is well up in the double digits and U.S. inflation is 2%, the rial should be falling in value relative to the dollar. If Rouhani followed Ahmadinejad's lead by translating dollar oil exports into rials at the free market rate, oil revenues would fund 30% of next year's budget instead of just 10%.

Then again, allowing the exchange rate to float to an appropriate level would present two major political problems. First, many Iranians are fixated on the exchange rate as an indicator of how well the economy is doing, incorrectly believing that the stronger the rial, the better shape they are in, regardless of how other crucial indicators are affected. Second, depreciated currency means more expensive imports, causing disproportionate pain to the urban upper middle class who form Rouhani's core constituency.

The president's monetary policy is dangerous as well. His budget speech said nothing about bailing out the banking system, which is effectively bankrupt. On the contrary, the new budget relies on "the transfer of financial assets" for one-fourth of its funding, or 1.25 quadrillion rials. Apparently, this means his government is counting on borrowing large sums domestically, either by reducing the money that could be deposited in banks or directly borrowing from these banks. Either approach would further strain a banking system that is perilously close to collapse.

Rouhani's tax policies are little better. As usual, his estimate of tax revenue was grossly optimistic, and his speech made no mention of tackling the pervasive problems of evasion and excess exemptions. Omid Ali Parsa, director of the Iranian National Tax Administration, estimates that 40% of the country's economic players are exempt from all taxes.

Furthermore, some of the recent economic changes lauded in Rouhani's speech seem dubious. According to him, Iran has added 2.3 million hectares of newly irrigated areas under his watch, yet farmers frequently complain that such areas have taken water away from long-established farms. Similarly, he bragged that his government has completed thirty-five dams, yet many of these projects are environmentally questionable, if not disastrous.

One sign of how far Rouhani had to reach to find good news was his declaration that inflation has been reduced to a mere 27%, down from 52%. Even that bit of rhetorical acrobatics required choosing the most favorable way of calculating inflation, the year-on-year method. In contrast, the Statistical Center of Iran reported that as of November, prices were up an average of 41% over the past twelve months compared to the previous year. Rouhani's boast is particularly striking because his priority after taking office in 2013 was to get inflation down to single digits—a goal he reached at the time, but only after implementing restrictive spending and monetary policies that brought the economy to the brink of recession.

The new budget does have one reasonably realistic element. It assumes that Iran's oil exports will be around 500,000 barrels per day at about $60 per barrel.

CAN IRAN SUSTAIN ITS CURRENT ECONOMY?

Not all the news surrounding Iran's economy is doom and gloom. Rouhani is correct that the non-oil economy has returned to growth after bottoming out earlier this year. And despite tough times, the government has continued to make substantial investments. For example, Iran's natural gas output from the offshore field it shares with Qatar has now exceeded Doha's output for the first time—a sharp contrast to eight years ago, when Qatar produced twice as much as Iran. Public infrastructure projects also continue apace, including roads, rail, and electricity.

Even so, the new budget suggests that Tehran has not fully adjusted to the loss of oil income. The government will need to take additional painful measures to bring the economy into balance. For all the talk about a "resistance economy," Iran remains heavily dependent on oil and oil-related industries (e.g., petrochemicals), whose share in export earnings is even higher than their contribution to government finances. And if Washington is successful at squeezing Iran's oil sales even further, the country's problems will only get worse. For instance, if U.S. sanctions force Tehran to sell oil at severely discounted prices, that would undercut government revenue almost as much as if Iran could not export that oil at all.

Patrick Clawson is the Morningstar Senior Fellow and director of research at The Washington Institute. ❖

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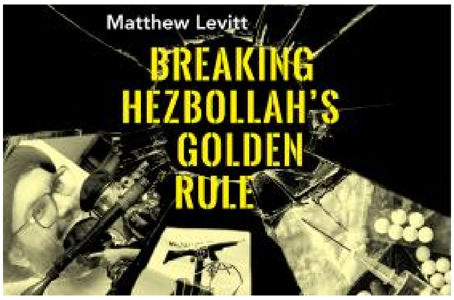

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