

Iran

Status Index 4,2 (Democracy: 1.6 / Market economy: 2.6)		Management Index 2,8	
System of government	Autocracy	Population	67.2 mill.
Voter turnout	69 % (Presidential Elections)	GDP p. c. (\$, PPP)	6,000
Women in Parliament	4.1 %	Unemployment rate	14 % (official number)
Population growth^a	2.7 %	HDI	0.719
Largest ethnic minority	24 % (Turkic-speaking Azaris)	UN Education Index	0.73
		Gini Index	43.0 (1998)
Data for 2001 – if not indicated otherwise. ^{a)} Annual growth between 1975 and 2001. Source: UN Human Development Report 2003.			

1. Introduction

The Iranian presidential elections of May 1997 saw the liberal Shia cleric Mohammad Khatami emerge the winner. After his inauguration in August 1997, Khatami initiated a cautious policy of state and social reform within the framework of the 1979 constitution of the Islamic Republic. The reform process was initially successful but faced varied and increasing challenges from the dominant conservative wing of the Iranian power elite, and since Khatami's re-election in June 2001 it has stagnated.

The main obstacle to transformation toward democracy and a market economy is the constitutional dualism between theocracy and republicanism, as seen in a revolutionary leader whose legitimacy derives from Islam and a president elected directly by the people. Ayatollah Ruhollah Khomeini, founder of the republic, developed the *velayat-e faqih* or "rule of the Islamic jurist" theory of the theocratic state, and established it as the central element of the new constitution of 1979.

The constitutional authority of the revolutionary leader, who is also commander-in-chief of the military and police forces, is greater than that of the president. Roughly speaking, the power elite splits into reform and conservative camps with the current revolutionary leader Ali Khamenei leaning toward the conservatives.

Economically, Iran holds an advantageous position vis-à-vis most other Middle Eastern states because of its rich natural resources. Iran is OPEC's second largest

producer with 9 % of proven global oil reserves and also holds the world's second largest natural gas reserves.

2. History and characteristics of transformation

Born in the 1978–1979 revolution, the theocratic government of the Islamic Republic of Iran not only experienced significant domestic upheaval and power struggles until 1982, but also waged a war against neighboring Iraq from 1980 to 1988. In the era of Ayatollah Ruhollah Khomeini, founder of the republic and its first revolutionary leader, domestic power struggles and war with Iraq facilitated the formation of an Islamic-authoritarian system.

However, absolute theocracy was moderated by the continued existence of parallel republican elements such as the Parliament (which had considerable authority), parliamentary and presidential elections held every four years, and a limited pluralism. Parliamentary representation is limited because persons judged to have questionable loyalty to the theory of *velayat-e-faqih ela* (rule of the Islamic jurist) are excluded from candidate lists for parliamentary elections. On the other hand, the Iranian Parliament exhibits an unprecedented vitality among Islamic states in terms of how debates are held, the capacity for legislative initiative and, if necessary, the power to stalemate executive authority.

Between 1979 and 1980, the entire banking and foreign trade sectors, and approximately 80 % of Iranian industry was either nationalized directly or transferred to the hands of revolutionary foundations which are, to some extent, government-subsidized to this day. During the war years the Iranian economy was planned and centralized. After the death of Khomeini in 1989, the somewhat pragmatically oriented wing of the power elite surrounding President Hashemi Rafsanjani (1989–1997) took over the executive branch and introduced policies focused on liberal economic reforms, though they were only minimally successful.

3. Examination of criteria for democracy and a market economy

3.1 Democracy

After beginning the reform process in 1997, Iran has for the first time since 1979 made progress toward transformation of the political order in some evaluated areas. One area has been considerably expanded freedom of speech and press, although both were curtailed again in 1999 by reactionary mandates from the judicial branch. Important power centers, including the judicial branch and the Council of

Guardians (composed of lawyers and effectively functioning as the upper parliamentary chamber), are dominated by conservatives who fight reforms connected to the rule of law and representation.

The Council of Guardians, which has veto powers, examines all adopted legislation for compatibility with Islamic law, interprets the constitution, and selects candidates for presidential and parliamentary elections based on loyalty to the system and to the theory of *velayat-e faqih*.

3.1.1 Political regime

(1) *Stateness*: Looking back over 2,500 years as a nation-state, Iran has a strong sense of national identity. A state monopoly on the use of force does exist, but is limited to the extent that the elected, pro-reform executive exercises only minimal control of the military, intelligence, security and police forces; these key positions are mostly in the hands of conservative partisans of revolutionary leader Khamenei.

Although Iran is an ethnically and linguistically fragmented country in which only 50 % of the population speaks Persian as a native language, the definition of and qualifications for citizenship are not significantly politically charged at the moment. The connecting link between most of the various ethnic groups and the core of national identity is the official state religion, (The Twelve) Shia; 85 to 90 % of the population are Shia members.

Constitutionally, all citizens have the same civil rights, but political reality demonstrates that members of the Sunnite minority and other non-Islamic religions such as Christians, Jews, Bahais, are discriminated against when senior appointments are made to the government, judiciary and army. The revolution of 1979 succeeded in fusing religion and the state, and pushed back secularization in the political, judicial, social and cultural spheres.

Public safety and order are guaranteed to a large extent, as is efficiency in the administrative system, although it suffers from mismanagement and corruption.

(2) *Political participation*: Universal suffrage is only partially present and the proper conduct of elections is not completely assured. The pro-reform government in power since 1997 has attempted to implement open and competitive elections; however, a lack of effective governing power has markedly limited the success of these efforts. The main obstacles are the constitutionally embedded imbalance of authority between the revolutionary leader and the president, as well as a varied and complex array of additional power centers—the majority of which is conservative.

The most important of these centers, which include the judiciary, the Council of Guardians, the Assessment Council, the Assembly of Experts, the Revolutionary Guardian Army and the revolutionary foundations, have effective veto power and are distinct political entities. They work against executive and legislative branches that have been controlled by reformers since the parliamentary elections in 2000. Implementation of the constitutional right to political organization and communication has been problematic. State broadcasting and television, and a part of the press are in the hands of the conservatives, and significant opposition parties are forbidden.

Political and civic organizations are restricted because a basic requirement for admission is loyalty to the system and the rule of *velayat-e faqih*. Islamic trade unions are permitted as long as they demonstrate loyalty to the system. Public debate and freedom of opinion exist in a basic sense and have been officially upgraded by the executive branch since 1997. However, these rights are subject to massive distortion and manipulation by the conservative judicial system, and are substantially limited when it comes to criticism of *velayat-e faqih* and its revolutionary leaders.

(3) *Rule of law*: Checks and balances are partially restricted because the three branches are entangled in the high-level power struggle between conservatives and reformers. From 1997 to 2000 the scope of action of the pro-reform executive was severely restricted by the conservative-controlled legislature and judiciary. Although the reformers won control of the legislative branch in the parliamentary elections of 2000, the judiciary, whose head is nominated directly by the revolutionary leader, continues to obstruct elected officials.

The judiciary has partially usurped executive authority (e.g. by appointing a judicial commissioner for foreign affairs) and has denied the presidential right to implement the constitution. It has ignored the constitutionally guaranteed immunity of elected parliamentary officials by bringing accusations against MPs over allegedly counter-revolutionary statements. The judiciary is institutionally separate, but it often acts as the *de facto* executive body of the revolutionary leader (who is the ultimate political authority in Iran) through its decisions and doctrines, even though this function is sometimes obscured.

Political and bureaucratic corruption is perceived as widespread by the Iranian people and is continually condemned by Khamenei. The judiciary, permeated by corruption itself, uses the fight against corruption as a tool against pro-reform opponents who are the targets of most accusations of corruption; corrupt conservative officials escape charges, or are at best inadequately prosecuted.

Civil liberties have been massively violated over a long period of time. From 1998 until the beginning of 2003, the judiciary closed more than 50 reformist newspapers; and, a large number of critical journalists, student leaders, clerics, authors, intellectuals, lawyers and even high-ranking officials from the executive and state administration close to President Khatami have been indicted and imprisoned under dubious charges. Several trials against leaders of national-religious opposition parties loyal to the constitution, but opposed to the power monopoly of the politicized Shia clergy, are still in progress.

3.1.2 Political patterns of behavior and attitudes

(1) *Institutional stability*: The constitutional authority of the executive, legislative and judicial branches is functional within the restrictions of the rule of law, and the most important institutions are held to be legitimate by those actors with influence in the political and social arenas. There are, however, considerable barriers to effective interaction *between* institutions due to the intra-elite power struggle. During particularly critical phases in the internal power struggle, individual ultra-radical conservatives have resorted to denial of the legitimacy of institutions dominated by their opponents. Thus, high-ranking officers of the Revolutionary Guardian Army, which is dominated by the conservatives, have repeatedly threatened to overthrow the president if his reforms would fundamentally change the system.

(2) *Political and social integration*: Democratically founded political parties, providing refined ideology and party platforms as in the West, exist only in rudimentary form. Secular parties and parties opposed to the constitution of 1979 are forbidden. Nevertheless, a limited pluralism exists within the revolutionary Islamic power elite that breaks down into three competitive movements: the left, moderate technocrats, and sociopolitical conservatives. The Islamic left and moderate forces have been united in a coalition since 1997 and comprise the reform camp.

Each movement includes a large number of parliamentary groups that play a role in politics as segmented, hierarchical, though primarily non-class-specific solidarity groups. These include professional organizations such as the bazaar merchants, clerics, engineers, and journalists; associations such as the student union; and advocacy societies (or NGOs) such as those representing women. Battles are fought over the allocation of power and economic resources by those groups which, in one form or another, have access to these resources; the revolutionary leader and the president have the definitive capacity to determine these allocations.

Significant polarization exists between the left/moderate reform coalition and the conservatives. Nevertheless, a consensus among all members of the power elite has

been maintained to ensure a minimum level of cooperation so that internal conflicts do not escalate beyond control. This functions to prevent existential threats to the foundation of the system and thus maintains the position of the current elite.

Observers estimate that a maximum of 10 % of the population approves of the *velayat-e faqih*, though this figure does not indicate disapproval of the system as such, its overall constitution or the achievements of the revolution. The election results for President Khatami in 1997 and 2001, 69 and 77 % respectively, reflect a continuing popular desire for reform of the current system, not its abolition through a new revolution.

Since 1997, the organizational landscape of civil society has differentiated considerably. For example, in 1999 Khatami paved the way to the creation of new, participatory and fundamentally democratic structures when he oversaw the community council elections mandated in the 1979 constitution for the first time in the history of the Islamic Republic of Iran.

3.2 Market economy

Iran has made only minimal progress toward transformation of its economic order. There are major transformation shortcomings with respect to planned economic structures, the sidelining of privatization issues, and the elimination of subsidies.

3.2.1 Level of socioeconomic development

The level of development of Iran, measured by the Human Development Index is relatively high compared with most other Islamic states of the Middle East and North Africa. The same holds true for the literacy rate (for 15-year-olds and above) which the UNDP estimated as 72.1 % in 1999, and the World Bank estimated at 85 % in 2001 based on information from the Iranian Central Bank. However, there is no reliable data on the distribution of income. According to a UNDP estimate, approximately 53 % of all Iranians lived below the poverty line in 1996.

A large portion of the Iranian economy is nationalized. According to the constitution of 1979, all large-scale industries including oil, steel, chemicals, textiles and raw material processing, as well as banks, insurance, energy, telecommunications, aviation and transportation systems must be owned and managed by the state. State-owned enterprises enjoy preferential treatment, including favorable government loans and exemption from most taxes and import duties. Although not affected by serious private competition, at least 60 % of public corporations run high deficits despite their monopoly status, a result primarily of mismanagement and corruption.

In 1999 the state employed approximately 20 million civilian workers and is thus by far the largest employer in a population of about 66 million (population figure for 2001).

In addition, Iran's economy suffers from a one-sided dependency on petroleum, the sale of which generates about 80 % of foreign currency income for Teheran. The oil sector accounted for around 40 % of GDP in the 1970s but has declined to approximately 20 % today. Yet income from oil exports still makes up approximately half of the state budget. While it is true that petroleum exports are a permanent source of income for the government, and that this income enables it to provide enormous energy and staple food subsidies for the population, the economy as a whole is extremely vulnerable to the fluctuation of international crude oil prices.

Repeated efforts since the beginning of the 1990s to reduce oil sector dependency through the diversification of export earning sources have largely failed. In 1998 Iran's financial situation deteriorated dramatically as a result of a slump in world crude oil prices. Higher oil prices in 1999 and 2000 provided a fiscal break, but did nothing to solve structural economic problems such as inadequate overall conditions for foreign investments.

3.2.2 Market structures and competition

Free market competition exists only in some sectors and is poorly regulated by institutions. Within the scope of the trade liberalization initiated by the pragmatic president Hashemi Rafsanjani (1989–1997), and continued by moderate-technocrat forces within the reform cabinet of President Khatami, Iran has made a modest effort to introduce uniform rules for all market participants. However, strong state interventions, regulations and management decisions still dominate the economic arena. Furthermore, the traditional “bazaar capitalism” supported by conservative factions of the elite leads to further distortions of competition. Foreign trade is subject to the control and direction of either the state or domestically powerful bazaar merchant associations and revolutionary foundations; this has contributed to Iran's isolation from the world market to a great extent. A few recent exceptions aside, all banks are state-owned. Despite the foundation of the Teheran Stock Exchange (TSE) in 1999, organization of an efficient capital market is still in its infancy.

3.2.3 Stability of currency and prices

From 1997 to 2001 Iran maintained a split exchange rate system, though this was abandoned in March in favor of a uniform exchange rate of 7,900 rials for one United

States dollar. In 1996, Iran had a foreign debt of approximately \$22 billion, but thanks to a rapid increase in oil prices to \$30 per barrel that began in 1999, Teheran was able to reduce its debt to approximately \$7.6 billion by 2001, or approximately 7.5 % of GDP.

Iran had taken measures to cushion the effect of a slump in petroleum prices during the most recent “fat years.” As determined by the five-year plan for 2000 to 2005 approved by Parliament in March of 2000, all oil revenues in excess of \$17 per barrel have been paid into a foreign currency reserve fund (the Oil Stabilization Fund or OSF), which holds \$12 billion at present.

Inflation, which ran to an estimated 40 % in the mid-1990s, was reigned in to 12.6 % by 2000. Meanwhile, the government, and in particular the central bank which has been striving for independence, have recognized that inflation control is an important building block of economic policy. However, consistent, effective control has only been exercised since 2000.

3.2.4 Private property

Although the right to property and regulation of property acquisitions are formally defined by law and by Islamic *sharia* law, they are not applied consistently; specifically, property rights do not have adequate legal protection against interventions by the state, revolutionary-Islamic foundations or politically influential individuals. In principle, private companies may freely operate as independent entities, but they are severely limited in practice by political, legal, social and economic obstacles.

State companies continue to dominate the strategic economic sectors, and the privatization of state concerns, which began in the 1990s under Rafsanjani and has continued under Khatami, has yet to achieve any lasting success.

3.2.5 Welfare regime

Social networks are well established to a certain extent, though they cannot ameliorate risks for all strata of the population. Poverty remains a risk for important segments of the population, but the majority of Iranians take advantage of state jobs and exorbitant direct and indirect subsidies for gasoline, heating oil and staple food items which include bread, rice, sugar and many more.

In addition, millions of Iranians receive social and financial benefits such as employment, medical services, school and university admissions, through institutions close to the regime. Institutions such as the Islamic Friday Preachers and other revolutionary foundations maintain networks all over the country, and the latter provide social control and stabilization for the regime by influencing the well-being and loyalty of broad groups of the population vis-à-vis the system.

3.2.6 Strength of the economy

Since the reelection of Khatami in 2001, the Iranian government has made an effort at crisis management geared toward macroeconomic stabilization. In the course of these actions, the government drastically reduced foreign debt to \$7 billion and initiated a prudent fiscal policy that has contributed to maintenance of 4.8 % average GDP growth between 1999 and 2002 despite a slight drop in world crude oil prices at the beginning of 2001.

The IMF expressed cautious praise in 2002 for this slight improvement of Iran's economic situation; however, praise was linked with insistent admonitions that Teheran not delay radical reforms in key areas, warning that without them a complete economic recovery would be impossible. Some of the recommended reforms include measures to fight unemployment, privatization, ending the squandering of state resources on energy subsidies, and reform of the inefficient state sector which absorbs the largest portion of the state budget (an estimated 60 %).

3.2.7 Sustainability

Iran has a basic, organized social network to alleviate poverty and societal risks that is partly based within families, and partly organized by the state or institutions close to the regime. The concept of environmental consciousness is little known in the overall population, despite the fact that Iranians are increasingly aware of the negative consequences of environmental degradation. An example is the auto and industrial exhaust in Teheran, one of the most polluted cities in the world, and its considerable health hazards to residents.

For the first time in the history of Iran, political consideration was given to the idea of ecologically sustainable growth through the creation of an environmental authority within the executive branch in 1997. So far, though, the authority has been relegated to a subordinate position in the push for economic growth.

Compared with most other states in the Middle East, Iran's health care system is satisfactory. According to UNDP estimates from 2002, 94 % of Iranians have access to health care institutions, 95 % have access to clean drinking water and 86 % to sanitary facilities.

There are institutions for education, professional training and research in important sectors. On the other hand, these institutions are very heterogeneous and show significant deficiencies, particularly within secondary and tertiary educational institutions. While the Iranian Central Bank gives the figure of 84 percent literacy at the primary level, government investment in secondary and tertiary education, professional training, and research are considered low to average.

4. Trend

(1) Democracy: The majority of the population has persistently advocated systemic reform. This is evident in the definitive election victories of reform candidates in the presidential elections of 1997 and 2001, the community elections of 1999 and the parliamentary elections of 2000, where reform candidates obtained from 70 to 80 % of the vote. The reform process has consolidated since 1997, but has shown signs of stagnation since mid-2000.

The conservatives, who continue to have the upper hand in the domestic power struggle, have used their veto power to prevent structural changes that would irreversibly open the system such as revision of the 1979 constitution. Nevertheless, Iranians have pushed consistently for change, especially women and youth. Unofficial estimates place 65 % of the population under the age of 21; thus, Iranian youth is a highly significant group.

Even the conservatives, or at least the more pragmatic among them, acknowledge that the ever growing pressure for change cannot be permanently evaded. This realization has heightened the willingness of the entire conservative group to find consensual solutions with the reformers. Fortunately, the present political system facilitates consensus-building on strategic decisions between the ideological movements within the power elite and high-ranking state executives, in particular between the revolutionary leader and the president.

Because of his compromises with revolutionary leader Khamenei, and in view of continued repressive measures by the judiciary against critics and opposition members loyal to the system, Khatami is increasingly criticized by radical reformers and young people who demand faster and more radical reforms. Despite the current

weakening of reform dynamics in the institutional arena, it is too soon to consider the reform process dead and it has, in fact, catalyzed two developments.

First, considerably expanded freedom of press and opinion has triggered a profound expansion of political dialogue. Secondly, Khatami has incorporated topics such as civil society, the rule of law, and pluralism into the political discourse, and this has initiated or strengthened a growing consciousness among Iranians regarding political rights and the possibility of participation. The dynamics of the development of this process may have far reaching consequences in the medium-term. Even if they drive the reform wing from power altogether, the conservatives can hardly undo both developments.

(2) *Market economy*: Overall, the fundamental development indicators for the assessment period show a slight improvement in development status. The poor institutional framework for market economic activity shows insignificant change. One reason is *'edalat-e adjtama'I*, or social justice, which is elaborated in the 1979 constitution; most political leaders, including the leftist majority in the executive and legislative branches are committed to *'edalat-e adjtama'I*. Given the power elite's understanding of the inevitability of economic reform, there is no open opposition to it. On the other hand, apart from a few moderate technocrats in the cabinet and , in Parliament, in economic research centers close to the government, and in the central bank, true economic reform lacks sufficiently committed advocates.

Furthermore, the "silent phalanx" opposed to privatization and state deregulation is very large and comprises, among others, powerful state institutions and revolutionary foundations that fear a loss of power, incompetent and corrupt managers, and workers and employees anxious about their jobs. The third five-year plan adopted in May 2000 offers little concrete remedy; it is as unrealistic as its predecessor in goals such as job creation. The plan obligates the government to implement ambitious market liberalization programs, privatize state enterprises, and create 3.8 million jobs by 2004. But many items of the program are vague, ambivalent and in general show little coherence and practicality. One example is the proposed vocational reintegration of labor released through privatization.

Likewise, there has been no progress to date on laws to implement the rule of law and de-politicize the judicial system, both of which would help dispel widespread mistrust among potential domestic and foreign investors of the legal security of invested funds.

5. Transformation management

5.1 Level of difficulty

Iran's economic situation presents an altogether ambivalent picture. Positive elements include: relatively high education levels achieved through massive investments since 1979; maintenance of a state monopoly on the use of force; a minor degree of ethnic-religious potential for conflict; limited polarization of the distribution conflict; average 5 % GDP growth since 1999; elimination of foreign debt; and state programs that successfully reduced the population growth rate from almost 4 % in the eighties to approximately 1.6 % at present.

Negative elements include: lack of progress in implementing the norms of the rule of law and in fighting corruption; human rights violations; sluggish privatization of state enterprises; lack of diversified foreign currency income sources; and maintenance of state energy subsidies which, according to a World Bank report in 2002, account for approximately 12 % of GDP.

5.2 Reliable pursuit of goals

In addition to political management of current problems, the executive branch is also attempting to pursue long-term, strategic economic goals, though they are often subordinated to short-term political gain. Thus, in the face of both conservative opposition and opposition within large sections of its own faction, the reformers in the executive and legislative branches have not taken decisive steps to implement cutbacks in the subsidy system or to reduce the number of state employees. The reasons are simple: On one hand, these reforms would reduce their chance of reelection, and on the other they carry the risk of provoking massive nationwide social and political unrest.

A long-term, convincing economic reform strategy has begun, initiated by a portion of the political leadership and most clearly supported by pro-reform Islamic technocrats in the executive branch and administration (with a stronghold in the central bank). The technocratic element recognizes the benefits that partial de-ideologization and political transformation—including integration into the world economy—would bring to Iran.

This segment has been responsible for incremental improvement in the climate for privatization since 2000, though no tangible results have appeared so far. Finally, moderate technocrats are the driving force behind the most recent government effort to conclude a comprehensive trade and cooperation agreement with the EU in the fall

of 2002, and they are behind Teheran's application for admission to the WTO, even though joining would necessitate massive deregulation of the state economy.

5.3 Effective use of resources

As noted above, the government squanders substantial resources on state subsidies for basic provisions, gasoline and energy. According to unofficial estimates, the government also spends about 60 % of its budget to sustain mostly unproductive state enterprises. Altogether, official state budget numbers are only conditionally representative, as they are minimally transparent. According to unofficial sources, a considerable portion of petroleum income flows directly into the special budget of revolutionary leader Khamenei, bypassing supervision by without the control of Parliament and thus obscuring the details of its intended use.

The state has also squandered opportunities to utilize the considerable human potential of Iranian natural scientists, intellectuals, technicians, physicians, administrators, economic experts and business people who reside abroad but comprise only a small percentage of the opposition. According to unofficial estimates, every year 200,000 young, well-educated Iranians emigrate to Europe or, in particular, the United States with its population of 2 million Iranians. Though the exodus of capital from Iran cannot be quantified, it is thought to be very high.

A primary motivation for the middle class educational and cultural elite to remain abroad are state restrictions in the social and cultural sphere, such as the body veil for women which is an integral part of the Islamic dress code. As early as the Rafsanjani presidency and later under Khatami, the state has wooed Iranian experts and financially sound investors willing to repatriate. However, results have been negligible. In the few successful cases, the professional reintegration of repatriates often failed because rational professional criteria did not apply, indicating that apolitical expertise was valued less than ideological loyalty to the party line.

5.4 Governance capability

The economic reform policy has produced some specific successes. One step forward, for example, is the legislation regulating the admission of foreign investments (the Foreign Investment Promotion and Protection Act, FIPPA) adopted by parliament in 2000, though domestically disputed for a long time. In September 2002, FIPPA was approved by the Assessment Council, which is the authoritative state organ for the arbitration of proposals disputed between parliament and Council of Guardians.

Under FIPPA, foreign corporations may now make investments in economic sectors that are also open to national private enterprises. However, collective foreign investment should not exceed 25 % of the overall market share in the sector in question.

The admission of the first private bank in December 2001 is another partial success. Two additional banks were admitted by the end of 2002, though they only have a collective market share of 2 % at the present time. In early 2003, the secretary of economic affairs announced that in the course of privatization and demonopolization, a decision was made to re-privatize nearly all banks nationalized in 1979, although no indication was given about the time frame. Despite repeated government avowals of adherence to the path of structural economic reform, the issue has remained a rhetorical one without any tangible results.

Through the end of 2002, no steps had been taken to liberalize foreign trade, to institute tax liability for revolutionary foundations, or to reduce subsidies. One reason has been the opposition of conservatives, state enterprises and bazaar merchants; another is the unexpectedly high foreign currency income from oil sales between 1999 and 2002 which has significantly reduced the immediate pressure for economic reform.

In order to reduce the unemployment rate of at least 25 % according to unofficial estimates, the government planned to create 765,000 new jobs per year. In October 2002, President Khatami had to admit in public that his government had been able to provide only 410,000 jobs during the two precedent years. In July 2002, Safdar Hoseini, minister for employment and social affairs, had to admit in a public statement that Iran was facing a dramatic unemployment crisis, since according to estimates of his ministry, another 5.5 million unemployed high school and university graduates would be added to the current (official) number of 3.2 million unemployed in the coming four years (IRNA, July 22, 2002).

In the last eleven years, costs for all staple foods and goods for daily supply have risen considerably for almost all Iranians, while real income has stagnated. Since 1997 alone, real costs for housing, heating oil and electricity has risen 70 % (Hayat-e Nou, November 24, 2001). At the end of January 2002, more than 10,000 teachers gathered in the streets because of economic hardship in order to demonstrate for better payment and better working conditions. The police broke up the protest and arrested 90 "gang leaders". In Isfahan, a similarly big protest rally of textile workers had taken place in October 2001 and had also been dissolved violently by security forces.

Increasing poverty, housing shortage and lack of perspectives of the people contributed in 2002 again to ever growing problems the Iranian government had to face fighting prostitution and drug addiction. Unemployment and missing perspectives are core causes for the extremely high number of drug addicts. Mohammad Fallah, head of the Iranian Drug Control Headquarters, estimated their number at at least 2 million people (IRNA, July 1, 2002). Drug crimes are on the other hand the main reason for the increasingly overcrowded Iranian prisons.

5.5 Consensus-building

Despite the vehement political conflicts between reformers and the conservatives, their respective leaders have finally come to consensus on one issue: preservation of the system. Yet because implementing this compromise has largely been achieved at the expense of the reform program, Khatami's support has suffered considerable erosion since 1999. To avoid completely losing his credibility vis-à-vis his supporters and to break the effective conservative blockade of the political reform process, President Khatami undertook a risky strategy change in September 2002 and became more confrontational.

He was behind two bills submitted by parliament that would provide for the expansion of his authority at the expense of the conservative-dominated judiciary and the Council of Guardians. Simultaneously, his closest advisers announced that he would consider resigning the presidency if the Council of Guardians and the Assessment Council turned down the proposals, effectively producing a state crisis which would seriously threaten the legitimacy of the entire system. Even though such a worst-case scenario is not out of the question, Khatami's latest showdown with the conservatives will more likely end with a compromise ultimately unsatisfactory to the majority of reformers and the public.

What makes this assumption probable is the perceived threat of the US-led invasion of Iraq to the entire Iranian power elite. For the benefit of national unity, addressing this perception will require a de-escalation of domestic disputes because both reformers and conservatives fear the possibility of becoming the next target of American attack or destabilization after the fall of the Iraqi Baath regime.

5.6 International cooperation

For the first time since 1979, a sustained effort to end Iran's international isolation and to normalize relations with the outside world appeared during the review period.

Previously, fluctuations in the domestic climate obstructed the development of a stable and consistent foreign policy.

The development of political detente with the West and the Arab world, although only moderately successful when initiated by President Rafsanjani, was continued more successfully and intensified under Khatami. Thanks to his domestic reform agenda and initiatives for peaceful dialogue between cultures, Khatami has been able to gain international confidence as a credible, dependable partner; and a majority of Iranian conservatives have both accepted and utilized this success because it benefits the regime as a whole.

As a result, Khatami had, by 2000, to a great extent normalized relations with Germany and the other EU states that had worsened dramatically following the judgment in the Berlin-Mykonos trial of 1997. Proof of rapprochement is President Khatami's visit to Germany in July 2000 which was praised by Chancellor Schröder as a substantial new beginning for relations. In September 1998, after Khatami publicly declared to the UN that his government would not enforce the death sentence against British author Salman Rushdie, diplomatic relations between London and Teheran were re-established and one of the biggest bones of contention between the EU and Iran was eliminated.

The Organization of Islamic Conferences (OIC) summit held in Teheran in December 1997, which was decisively influenced by Khatami's new political agenda, brought Teheran a lasting detente in relations with the pro-American Arab states, with Saudi Arabia at the forefront. In the months following, Teheran agreed with Riyadh on coordinated attitudes in OPEC and even concluded a number of political and economic cooperation agreements with its former ideological arch-enemy including a security agreement in 2000. However, Khatami has not been able to make any progress toward re-establishing relations with the United States, which have been suspended since 1980.

Insurmountable domestic opposition in both Iran and the United States are at the root of this lack of rapprochement, even though resolving this issue would have been extremely important to Iran's economic restoration. Iranian conservatives around revolutionary leader Khatami, and the US Congress maintain entrenched positions resulting in stalemate. During the review period, the United States has continued to allege that Iran is the main sponsor of international terrorism, that it is striving to develop weapons of mass destruction, and that it is undermining the peace process in the Middle East. The United States has sustained economic sanctions against Teheran imposed in 1995 and 1996, which aim above all to damage Iran's vital oil sector.

Despite this, Iran has to a large extent succeeded in neutralizing the negative consequences of the American sanctions through agreements with various French, Italian and Canadian oil companies. Nevertheless, George W. Bush's administration extended sanctions in 2001, and after September 11, 2001 President Bush intensified American hostility by publicly ostracizing Iran as part of his international "axis of evil" along with Iraq and North Korea in January 2002.

Unimpressed by this most recent demonization by the United States, the EU continued negotiations with Teheran on a possible trade and cooperation agreement, programs for political dialogue, and anti-terror cooperation in December 2002. From the standpoint of the EU, improvement in the human rights situation is the main prerequisite to strengthening the economic and commercial cooperation desired by Iran.

6. Overall evaluation

In view of the baseline conditions for transformation, current status and participants' political achievements, we arrive at the following conclusions:

(1) *Initial conditions*: Baseline conditions for a democratic and market-economic transformation in Iran only existed in rudimentary form. Although there are no problems with state and national identity or domestic stability, this is balanced by the absence of constitutional and democratic institutions and traditions. A primary obstacle to the opening of the political system and the development of strong civic organizations is the continued existence of a theocratic-Islamic authoritarianism represented by the institution of the revolutionary leader. Additional shortcomings include the continued existence of state-controlled and socialist structures in the largest sectors of the economy and Iran's continued dependence on petroleum as its main source of foreign exchange.

(2) *Status*: The evolution of the democratic transformation has been very brief. The reformers around Khatami introduced the topics of civil society, the rule of law and pluralism into political discourse, and now they have been accepted to a great extent even by Khatami's opponents. However, their implementation has failed because of the stalemate tactics of the conservatives and the constitutionally entrenched uneven distribution of power between the executive and legislative branches on the one hand, and the revolutionary leader on the other. The evolution of market-economic transformation has been slightly longer. Nevertheless, regardless of recent, limited progress in the areas of fiscal policy, the beginning of opening toward foreign investors, and the admission of private banks, no substantial measures have been taken to restructure the economy.

(3) *Management*: Despite some specific successes in the reform process since 1997, the verdict on the participants' relative management performance is that it is altogether unsatisfactory. All actors, whether reformers or conservatives, desire better cooperation with external actors. Of primary importance is the reorganization of relationships with the Arab world and aspiration to close economic cooperation with the EU states, which is considered a potential counterbalance to the United States. Teheran has high hopes that this cooperation will lead to a neutralization of Washington's political and economic containment policy.

However, without further progress in the reform process as required by the EU, in particular regarding the implementation of the rule of law, human rights and the freedom of press, opinion and parties, true, deeper economic cooperation will remain an illusion. This progress will require changes to the constitution, but despite a high level of popular support, the reformers are too weak to implement these changes because of the uneven distribution of power. Changes to the constitution will also be necessary for a comprehensive de-nationalization of the economy; this effort has failed so far because of opposition by a majority of both conservatives and reformers.

7. Outlook

Iran certainly has a unique position among most of the states of the Middle East in terms of transformation progress. No other authoritarian Islamic state shows a comparably intensive and apparently promising political dialogue about how to balance traditional Islam with Western-democratic values and concepts as the dialogue in Iran triggered by the reform process that began in 1997. However, this should not obscure the fact that the actual transformation progress achieved during the review period was within narrow limits.

Much will depend on the future course of domestic power struggles among the reformers, and the influence the behavior of external actors like the United States will have on the development of events in Iran. Both developments must be regarded as unpredictable imponderables. If President Khatami fails in his efforts to expand his authority, it can be expected that a majority of Iranians will turn away from the reform process in disappointment and this will give rise to a significant radicalization of certain groups currently on the fringes of the political reform spectrum.

The possible consequences would be a rapid increase in the potential for political unrest as well as a renewed surge of ultra-authoritarian trends and increasing influence by the conservatives. Both are likely to have a negative effect on the strengthening of the democratic, market oriented transformation process.