On the 10th December 2018, President Hassan Rouhani delivered his draft budget to the Majles, Iran's Parliament. Spanning the years 2019-2020 (Persian year 1398), the draft budget reflects the difficulties in which Iran finds itself since the reimposition of US secondary sanctions.

A higher budget with shaky grounds:

Using the new official rate of 57,000 IRR per USD, the 1398 budget amounts to $76 billion. Although Iranian media reports that next year's budget is 12% higher than the year 1397 (2018-2019), our calculations show a higher percentage of around 17%, hinting at higher fiscal pressures next year. Already, the seven first months of the year 1397 have registered a budget deficit 74% higher than expected in the budget unveiled at the end of 2017. While the budget deficit this year is probably not going to exceed 1.5% GDP, the 1398 draft budget is set to reach a level of at least 3.5% of the GDP.

With the goals of maintaining economic stability, boosting growth, expanding redistribution, reducing poverty and supplying public goods, the Iranian government has a lot to grapple with, especially in this time of stringent economic sanctions and dropping oil revenues. While this year's budget relied by 34% on oil revenues, next year's will cut this dependence to 27% only, nearly reaching the record low of 2016 at 25%. Although hurtful, economic sanctions undeniably force the government to diversify its revenue sources. In the last five years, big changes have been operated in Iran's taxing system, so much that in 1397 around 45% of the budget relied on taxes on income, corporations, wealth, imports as well as goods and services.

For next year, the government hopes to export 1.5 million bpd per day at a benchmark price of $54 the barrel. Although the barrel price benchmark matches current market prices and is far more realistic than the $80 benchmark adopted by Saudi Arabia, it remains highly unlikely that Iran will be able to export 1.5 million bpd per day throughout 2019 and early 2020. Already for November 2018, data from tankertrackers.com shows that Iran only managed to export 1.1 million bpd during that month. US waivers attributed to 8 countries have not been used by all beneficiaries since South Korea, Greece and Taiwan have decided not to take the risk of unloading Iranian crude. With only China, India, Turkey, Italy and Japan allowed and willing to import Iranian crude, Tehran is only guaranteed to export less than 900,000 bpd per month without facing American barriers. Moreover, this is solely a short-term respite as waivers will come to an end by April 2019 and are unlikely to be renewed thereafter.

Complete details on the 1398 budget have not yet been released. It is not yet clear how much the government hopes to get from each revenue source and current information might be subject to change. However, considering the draft budget, it seems that Rouhani hopes to earn $30 billion in oil revenue next year. Taking into account what has previously been said, this figure is undoubtedly inflated and does not reflect reality. Rather, with probable exports of 1 million bpd, Iran is more likely to earn around $20 billion in oil revenues next year. Keeping oil prices around $54/barrel. With the current economic situation with youth unemployment as high as 21.6% and women unemployment at 40%, it is highly unlikely that the President will be able to increase the government's revenue extraction power, especially considering skyrocketing inflation.

Higher expenditure next year is meant to minimise the impact of sanctions on people:

Nonetheless, next year's budget still includes a year-on-year $7.7 billion increase in expenditure. Higher investments will be made in the scientific realm, with $1 billion earmarked for laboratories' equipment and a 71% increase in the sum allocated for centres of science and technology. Government spending in the tourism sector is set to double while plenty of funds will be allocated to education, with a year-on-year increase of 28%. Indeed, $7.7 billion will be allocated for schools, of which $160 million for schools in deprived areas. These expenditures are highly needed in the country, considering that more than 40% of Iran's schools do not meet standards set by the Ministry of Education. On the 19th December, a private school in Zahedan, the capital of Iran's most deprived region, burned down, leaving three schoolchildren dead as a result of an antiquated heating system.

Overall, the next budget reflects the dire needs of the Iranian population. The government has earmarked $14 billion of oil revenues for the purchase of basic goods and medications for people's welfare. Taking into account our previous estimates for Iran's 2019-2020 oil revenues, this means that the country will allocate nearly 70% of its oil revenues to guarantee Iranians access to necessary products in a time of sanctions. Additionally, $25 billion are earmarked for subsidies. It yet remains unclear whether the government's scheme subsidising imports is part of this amount. If separate, this would mean that with amounts earmarked for subsidies, import allowances, poverty reduction aid and a $2.6 billion regional inequality equalisation scheme, nearly 55% of the budget is allocated to diminish the financial pressure of sanctions imposed on people. Adding the sums earmarked for development, the $6 billion allocated for social security and $350 million set aside for pension equalisation, nearly 80% of the budget becomes exclusively focused on making sure that 1398 does not lead to a spike in protests.

Although not unforeseen in the history of the country, considering its relatively strong labour unions, Iran has seen an increase in protests from workers in sugarcane factories, teachers and laid off employees from one of the country's most successful tyre company. The dire situation in which these protesters find themselves is not necessarily the result of sanctions. Kian tyre, the company which laid off workers, did so after being sold to private actors who used the subsidised dollars allocated to the company to enrich themselves instead of improving the company's operations, thus leading them to fire employees. Apprehensive of such protests, the government has promised to increase the salary of civil and military personnel by 20% next year.

Subsidies themselves are a way to lower the pressure off the back of people. Despite readopting a card capping petrol purchases in late November, a move which could have augured higher prices at the pump, Iranian officials have guaranteed that petrol prices will remain the same, at $0.1/L. Initially, the 1397 budget entailed petrol price hikes, which were quickly removed as soon as the December 2017 protests started. Additionally, the government subsidies aim at salvaging the country's agricultural sector and decaying environmental situation. The budget allocated for the environment has been increased by 84% whilst aforementioned subsidies include aid worth $1.4 billion for buying wheat. Sums allocated for drinking water and agriculture have both been increased by 20%. The draft budget also promises to reconstruct 300,000 old building and to triple the amount given for urban regeneration.

How is Iran going to pay for the spending hike?

The aforementioned expenditure increase at a time of low oil prices and decreasing oil revenues begs the question of how will Iran afford its new budget. Contrary to Saudi Arabia which is highly likely to make good use of international debt markets, Iran's Plans and Budget Organisation has placed a ceiling for new debt at $9.8 billion, which gives the government little free-hand to leverage its spending. With debt levels at 49% GDP and decreasing access to international financial markets, it is understandable that the state does not want to over-leverage its finances. Indeed, the 1398 budget seems to put aside $5.5 billion to redeem previous years' bonds, thus showing the government's willingness to keep debt at low levels. Given the high interest rate on debt for Iran, 1398 will certainly prove to be a scarce year for the country in terms of bonds issuance, as it is preferable not to issue much bonds considering the difficulty in repaying them.

Therefore, the government will have to be ingenious in finding alternative revenue sources that do not put pressure on the population. An option will be to lower the share usually allocated to the National Development Fund (NDF), Iran's sovereign wealth fund. Since the drafting of the 6th Development Plan two years ago, 34% of oil revenues are required to be deposited in the NDF. Accordingly, the government hopes to earmark $11.4 billion for the fund. But considering the lower than expected oil proceeds, this figure is highly implausible. Earlier, President Rouhani wanted to altogether scrap next year's allocations to the NDF but the Supreme Leader Ali Khamenei advised that at least 14% of oil revenues should be put aside for development. If the draft budget is revised along those lines, the NDF would only receive $4.2 billion, thus freeing $7.2 billion for other purposes.

At this point, an inevitable scenario for the government is to devalue the currency. Already, the draft budget governmental rate is 57,000 IRR to the USD, a near 25% increase from the previous 46,000 IRR rate. Iran's rial has had a tough year in 2018, with its value decreasing by as much as 70% until October. Since then, the currency has appreciated by 30% and hovered around 100,000 IRR to the USD. For many economists, this rate reflects the currency's real and competitive value. It is therefore likely that by the end of next year, Iran's government will significantly devalue its official rate to bring it closer to the open market rate. Thanks to more fruitful previous years, the government also has reserves on which to hold in order to survive the current economic crisis. Statements from economists hold that the government holds as much as $100 billion in reserve. To bolster its budget, the government could well sell these hard currencies on the open market to get as much purchasing power as possible.

Nonetheless, these measures are highly inflationary. Devaluing the Rial and printing money are likely to cause prices to skyrocket even further. Hossein Raghfar, an Iranian economist, believes that the inflation rate could reach as much as 80 to 100% by the Iranian New Year in March 2019 if the government decides to devalue its official rate to 80,000 IRR to the USD. Although these rates might be exaggerated, Iran is already facing double digit inflation rates, put at 15% by the Central Bank, but more likely to be twice much in the previous months according to our own estimates. Therefore, Iran will continue to greatly suffer from currency devaluations and inflation, which in itself is more the result of economic mismanagement by the government than the direct result of sanctions.

Corruption: an ever-lasting Iranian topic:

On the 9th December, the world celebrated Anti-Corruption Day and America's Secretary of State declared that the Iranian government was "full of corrupt hypocrites". His colleagues at the State Department did not lose time in disclosing the extent of corruption in the Islamic Republic. Their publications mentioned the names of Sadegh Mahsouli, an IRGC general worth billions thanks to lucrative oil and construction contracts; Ayatollah Sadeq Larijani, suspected of embezzlements by the millions; Ayatollah Nasser Makarem Shirazi who is said to have earned millions through imports and sales of sugar; Ayatollah Mohammad Emami Kashani, rich by the millions thanks to lucrative mines; and above all Ayatollah Ali Khamenei who sits on a foundation called the Execution of Imam Khomeini's Order (EIKO), which according to Reuters is worth $95 billion.

Although these accounts should be taken with a pinch of salt considering the partial nature of the State Department, corruption has itself been a hot topic within Iran. Earlier this month, 30 men were jailed with sentences as long as 20 years for "economic crimes". The judicial bodies handing these sentences were the fast track courts established in August 2018 on order of the Supreme Leader. In November, these courts handed the death penalty to Vahid Mazloomin and Mohammad Esmaeili Ghasemi, accused of hoarding gold coins. Far from being legitimate tools fighting corruption, these courts represent blatant violations of due process and reflect rash decisions to calm public outrage. For many years, the elites within the Islamic Republic, on both sides of the political spectrum (conservatives and reformists) have involved themselves in a game of name calling and finger pointing.

Recently, the appointment of Rouhani's son-in-law to Iran's geological survey body, without him having the required qualifications, led to public anger, especially among the conservative media. Yet, conservatives themselves have not been exempt from corruption scandals. Amir Mohsen Moradian and Mohammad Sasha Sobhani, two sons of former ambassadors (to Denmark and Venezuela) who more inclined towards the conservative camp, have drawn the ire of the public on social media after pictures of their lifestyle, deemed luxurious, were published online. Overall, the social environment in the Islamic Republic is growing toxic, with each faction condemning the other of corruption, sinful behaviour or luxurious lifestyle. These scandals are themselves followed by the society at large as issues surrounding inequality are highly discussed among Iranians.

A report from the Omid for Iran foundation, dated September 2018 has done a good job at tracking the extent of corruption in the country, particularly relating to the energy sector. According to this foundation, corrupt patterns have been overwhelming during the Ahmadinejad presidency of 2005-2013, whereby $1 trillion of oil proceeds have simply disappeared as a result of corruption. During those years of high oil prices and production, Iran is said to have created no new job and lost around 500,000 industrial workers due to the bankruptcy of 2500 firms. Although anti-corruption has rhetorically been at the centre of Rouhani's agenda, previous patterns and newer methods of corruption continue to riddle Iran's economy. Although relatively safe compared to other nations in the Middle East, Iran is one of the least transparent as there are so many blind spots surrounding large state-owned companies which still control a majority of the economy. While the UAE are the 11th country in the World Bank's Ease of Doing Business Index, Iran ranks 124th.

The country's officials have done a terrible job at maximising the country's energy resources as it is believed that as much as 14% of the production levels are lost in oil fields. With poorly negotiated contracts which force the National Iranian Oil Company to sell gas at 1/14 of market prices, and a high gas flaring level, the same disastrous management found in the oil industry is also to be found in the gas sector, for which Iran accounts for the first or second largest resources in the world, depending on sources. Not only having poor return on investments in one of its most crucial economic sector, Iran's sovereign wealth fund is also cause of great concern as it is believed that as much as $150 billion have exited the NDF, formerly known as Oil Stabilisation Fund, between 2006-2011. This sum being obviously unaccounted for. With an extremely low score of 1/10 on the Sovereign Wealth Fund Institute Transparency Index Score, the NDF lags far behind regional peers such as the State Oil Fund of the Republic of Azerbaijan (SOFAZ) or the UAE's Mubadala, both scoring 10/10,

Although negligible considering the overall economy, Iran is also guilty of sending considerable funds to groups considered terrorists by numerous Western governments. It is believed that the country spends at least $1 billion a year to fund Iraq's Hashd Al-Shaabi and Lebanon's Hizbollah. Understandably, the financial extent of Iran's foreign interventions is far larger, with dozens of billions already spent to salvage Bashar Al Assad's regime in Syria. Yet, despite the unavailability of clear data on this topic, it remains unlikely that Iran could salvage its economy if it repatriated all the funds it allocates for its foreign interventions.

A last point to cover is the role of religious foundations in attracting funds that could be earmarked for other purposes. For the 1397 budget, the government significantly increased the sums allocated to such foundations. This caused great anger among the population and partly caused the protests of

December 2017 and January 2018. Next year's draft budget does not make any mention of these foundations, thus probably showing the government's wish to not cause protests. For instance, the budget of the Seminary Services Centre and the premium given to unemployed clergymen was increased from $222 million in 1396 (2017-2018) to $249 million in 1397 (2018-2019). Other foundations such as the Women's Seminary Policy Council, the Islamic Culture and Communication Organisation and the Islamic Publicity Organisation had respective allocations of $71 million, $62 million an $10 million.

More troubling for Iranians, foundations revolving around individuals, like the Library of Ayatollah Moreshi Najafi, also got funds, in this case worth $2 million. Although relatively small amounts, these allowances begged the question of social justice and appropriate budget allocation. These foundations are not required to pay taxes and they have a complete free-hand in disbursing tax-payers' money. Although it is true that a lot of their activities revolve around charity, their existence continue to trouble government efforts for greater budget transparency. This year, the Astan-e-Razavi Qods, the foundation looking after Imam Reza's shrine in Mashhad was eventually asked to pay taxes, which its head, former presidential hopeful Ibrahim Raisi did reluctantly. However, it is estimated that the amount paid for taxes by the foundation is only $833,000; a rather meagre sum considering the billions of dollar held by the foundation. All-in-all, with the aforementioned policies of selling hard currencies, using reserve funds and diverting from the Development Plan's rules, it seems that transparency is going to fall victim of next year's budget.

For a more in-depth view of Iran's economy under sanctions, please view our November 2018 Economic Risk Series: https://bit.ly/2AcE4uv.

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