CHAPTER THREE

THE MACRO ECONOMIC ENVIRONMENT AND STATUS OF SSIs IN IRAN
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PART 1: THE MACRO ECONOMIC ENVIRONMENT IN IRAN

3.1 INTRODUCTION

In this chapter the macroeconomic environment of Iran will be reviewed with reference to ten principal macroeconomic variables over a Six-year period (1998-2003) and also status of SSIs will be reviewed. Since the macroeconomic environment affects all economic activities regardless of the size of the enterprise concerned, this discussion will help to understand the degree to which the challenges faced by Iranian SSIs are rooted in the prevailing macroeconomic conditions, or related exclusively to their size and position in the economy.

3.2 ECONOMIC GROWTH

A new era in the history of Iran’s policy formulation emerged in 1995, when many economic variables came under the control of the government, the exchange rate was stabilized; inflation was controlled through the adoption of contractionary monetary and fiscal policies. The resulting restoration of socio-economic stability has helped the Iranian economy to go through a transitional stage of development from a relatively closed and controlled economy to a more open market-oriented economy. Table 3.1 shows both GDP at constant 1997-1998 market prices and its growth rate from 1997-98 to 2002-03.

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP 1997-1998 (Rials bn)</th>
<th>GDP 2002-2003 (Rials bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997-98</td>
<td>309,940</td>
<td>379,838</td>
</tr>
<tr>
<td>1999</td>
<td>304,941</td>
<td>355,554</td>
</tr>
<tr>
<td>2000</td>
<td>320,069</td>
<td>3,555,54</td>
</tr>
<tr>
<td>2001</td>
<td>330,565</td>
<td>3,555,54</td>
</tr>
<tr>
<td>2002</td>
<td>330,565</td>
<td>3,555,54</td>
</tr>
<tr>
<td>2003</td>
<td>330,565</td>
<td>3,555,54</td>
</tr>
</tbody>
</table>

Table 3.1: GDP at constant 1997-1998 market prices (Rials bn, Iran’s currency)

Despite the fact that Iran’s economic growth in recent years can be partly attributed to non-oil export activities and domestic industrial production, oil production and exports still dominate the economy. The growth of the Iranian economy will consequently remain vulnerable to shifts in oil prices, which are currently projected to average $50-60/b for the foreseeable future. The rate of GDP growth slowed in real terms between 1997/98 and 2001/02, but was estimated to have picked up again to 11.07% in 2005/06. Due to the economic stabilization, introduction of economic
reforms and reduction of inflation, the productivity of the labour force in Iran has also increased. As shown in Table 3.2, the productivity of labour rose from Rials (Iran’s currency) 1,090 per worker in 1997/98, to Rials (Iran’s currency) 1,162 in 2002/03, which represents a 6.6% increase in 5 years. Most of the increase in productivity is due to the improvement of macroeconomic and political environment that began with the deregulation and liberalization policies.

Table 3.2: Labour productivity, 1997/98-2002/03

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>In Rials productivity worker</td>
<td>1,090</td>
<td>1,115</td>
<td>1,125</td>
<td>1,154</td>
<td>1,155</td>
<td>1,162</td>
</tr>
</tbody>
</table>


3.3 INFLATION
The published data shows that the annual rate of inflation in the 2002/03 was 15.6%. This is the reasonable inflation rate that Iran has experienced during the past five years. Sustained price control, greater efforts to control liquidity growth and an increase in foreign exchange revenues are thought to be behind this fact. Recent forecasts suggest that a new inflationary period may begin in 2004/05.

3.4 PUBLIC FINANCE
In 2002-03, the total general expenditure of the government was predominantly financed by oil and gas revenue (47.4%) and by taxes (26.8%); with the remaining 25.8% being financed by other sources of revenues. This composition is not expected to change much in the foreseeable future. Tax reform has been a hot issue in parliament for the past decade. The ratio of total tax collected by the government to GDP did not exceed 5-6%, which is very low compared to countries with the same income level. Consequently, the budget revenues continue to be dominated by oil and gas income.

3.5 INVESTMENT
3.5.1 DOMESTIC INVESTMENT
The ratio of gross investment to GDP at constant market prices hardly reaches a modest 17%, which is insufficient to generate a healthy rate of economic growth. As shown in table 3.3, the private sector represents the major source of domestic investment. Total gross investment (Private Investment) increased from Rials 62,143 bn
in 1997/98 to Rials 90,763 bn in 2002/03. While the growth of private sector investment is satisfactory, the general trend of investment in Iran is uneven. Two major factors explaining the inconsistent trend are:

a) The existence of an unfavorable business environment and
b) A sharp decrease in national savings during recent years.

Apart from a general improvement in the national business environment, the government also aims to encourage foreign direct investment (FDI) in the hydrocarbon and other sectors in order to stimulate economic growth. However, the level of FDI in industries other than oil and gas has not proved sufficient to affect any significant growth.

Table 3.3: Gross investment at constant prices, 1997/98-2002/03 (Rials bn)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Capital Formation</td>
<td>90,101</td>
<td>91,505</td>
<td>95,267</td>
<td>108,762</td>
<td>121,826</td>
<td>134,971</td>
</tr>
<tr>
<td>Private Investment</td>
<td>62,143</td>
<td>57,269</td>
<td>61,671</td>
<td>72,942</td>
<td>81,022</td>
<td>90,763</td>
</tr>
<tr>
<td>Government Investment</td>
<td>26,958</td>
<td>34,236</td>
<td>33,598</td>
<td>38,820</td>
<td>40,804</td>
<td>44,208</td>
</tr>
</tbody>
</table>

Source: Central Bank of Islamic Republic of Iran

3.5.2 FOREIGN DIRECT INVESTMENT (FDI)

Because of its closed and strongly state-controlled economy, Iran has not been able to attract significant foreign direct investments. In 2002/03, FDI amounted to a very modest US$ 3.85 per capita, which compares with US$ 12 in Turkey, US$ 31 in China, and US$ 68 in Malaysia. Within the government, there are still many divergent views and approaches towards FDI.

The share of FDI in gross capital formation has indeed been very low, as is indicated in the World Development Indicators 2001 published by the World Bank. This shows the share in Iran to amount to only 0.42%, whereas the UK scores 34.4%, China 10.5%, Malaysia 8.8%, Pakistan 6.0% and Turkey 1.81%. The total value of FDI during 1997/98-2001/02) fell short of US$ 2 bn. The distribution of FDI by source is shown in table 3.4. Europe and Canada have been the main investors in Iran. From Europe, Italy with US$ 371.82 m. and France with US$123.14 m. are the biggest investors in Iran.
### 3.6 WAGE AND LABOUR MARKET

A comparison of the wage index and the consumer price index (CPI) for the past six years is in Table 3.5. This shows that the ratio of the wage index to the CPI has decreased from 0.96 in 1998 to 1.22 in 2003. This implies that wage increases compensate for inflation, and that the purchasing power of the labour force consequently increases during this period.

<table>
<thead>
<tr>
<th>Year</th>
<th>CPI</th>
<th>Wage Index (Dwelling)</th>
<th>Ratio (Wage Index / CPI)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997/98</td>
<td>100</td>
<td>113.30</td>
<td>0.96</td>
</tr>
<tr>
<td>1998/99</td>
<td>118.10</td>
<td>128.50</td>
<td>0.91</td>
</tr>
<tr>
<td>1999/00</td>
<td>141.80</td>
<td>142.30</td>
<td>0.89</td>
</tr>
<tr>
<td>2000/01</td>
<td>159.70</td>
<td>157.90</td>
<td>1.13</td>
</tr>
<tr>
<td>2001/02</td>
<td>177.90</td>
<td>201.40</td>
<td>1.22</td>
</tr>
<tr>
<td>2002/03</td>
<td>206.00</td>
<td>252.80</td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of Iran

### 3.7 FOREIGN TRADE

One of the most important policies adopted by the government involved the stabilization and unification of the exchange rate. The introduction of the floating exchange rate in 1999/00 served to stabilize the exchange rate, which in turn helped to stimulate non-oil exports. The non-oil exports increased from US$ 3.18 bn in 1997/98
to US$ 7.18 bn in 2002/03. As explained a unified exchange rate will remain an
important goal of the Central Bank of Iran, despite fears of the possible inflationary
impact of such a unification policy.

3.8 PRIVATIZATION

The topic of privatization (i.e. the transfer of ownership from the government to
the private sector) was raised in Provision 23 of the First Socio-economic and Cultural
Development Plan initiated in 1989/90. The policy's implementation was foreseen in
further resolutions adopted by the Cabinet in 1991 and 1992, and was followed by the
publication of a list of almost 400 government-owned firms earmarked for privatization.
The objective was to raise the efficiency of these firms while decreasing governmental
involvement in economic activities, in order both to stimulate the economy and
optimize the utilization of national resources.

In subsequent years, several other measures have been introduced to promote the
divestment of state ownership in industry, including:

- The Law on the Transfer of Government Shares to the Disabled and Workers;
- The Law of the Islamic Consultative Assembly (Parliament) of 1994;

These policy measures have all provided the background for facilitating the
privatization process in the years prior to the introduction of the TFYP in April 2000,
albeit not in a consistent manner.

According to statistics released by the Privatization Organization, the value of
government shares transferred to the private sector in 1992-2000 amounted to Rials
7.8328 bn. An evaluation of these statistics reveals that ownership transfer on the basis
of Provision 35 of the National Budget Laws recorded particularly strong growth in
1998-2000, when it accounted for 58% of all ownership transfers. In overall terms,
however, the sale of state assets during 1991-2000 has fallen well short of the targets
stipulated in the First to Third Socio-economic and Cultural Development Plans, with
only a modest budgetary reserve of US$ 11 bn. having been built up for the beneficiary

1 Central Bank of Islamic Republic of Iran, Year book 2003.

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welfare institutions during this period. The principal foci of these privatization efforts were the Iran Development and Renovation Organization and the Iran National Industries Organization affiliated to the Ministry of Industry, and the Financial Institute of Industrial Units’ Ownership Transfer affiliated to the Ministry of Economic Affairs.

It bears mention, however, that a number of state-owned organizations have succeeded in transferring shares through the Tehran Stock Exchange. A case in point is the Ministry of Oil, which transferred shares in the Petrochemical Industries National Company. Nonetheless, exact statistics regarding the total value of these shares have not been published. According to Provision 10 of the National Budget Law of 1999, the government’s shareholding in state-owned firms is to be transferred in the coming years to their main shareholders, namely the Social Welfare Organization and the National Retirement Fund to cover its debts to these institutions.

With the adoption of the TFYP, which concentrates on the organizational aspects and ownership transfer of state-owned firms, it is widely anticipated that the privatization process will gain momentum. The Plan contains many important aspects, such as the definition of the scope and methods of the transfer of ownership, the creation of independent institutions for ownership transfer, transfer through instalments, insurance schemes for the transfer of state-owned firms in case of unintended mistakes, adjudication bodies, and the creation of a high council of ownership transfer. There are, however, several shortcomings that deserve attention as well. For example, the creation of specialized holding companies is a topic that has not been sufficiently clarified and there is consequently no consensus on how they should operate. This is delaying the launch of such organizations. In addition, the issue of the firms’ tax debts incurred prior to the transfer of ownership needs attention.

3.9 INFORMATION AND COMMUNICATION TECHNOLOGY

Research carried out at the Industrial Management Institute¹ in Tehran has sought to measure and rank the growth and potential of information technology (IT) of different countries. To achieve this objective, the study used two separate indices: the

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¹ Imanirad, Morteza and Bakkak Ghobi, "Position of IT Growth and IT Potential in Iran", Industrial Management Institute, Tehran, 2001, P.86
first measured the growth status of IT, while the second measured the IT potential. The variables employed for developing these indices are presented in Table 3.6.

Table 3.6: Variables indicating IT growth and potential

<table>
<thead>
<tr>
<th>IT Growth</th>
<th>IT Potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Telephone line per 100 persons</td>
<td>1. Spending on R&amp;D as percent of GDP</td>
</tr>
<tr>
<td>2. Computers per 1,000 persons</td>
<td>2. Power supply per population</td>
</tr>
<tr>
<td>3. Internet hosts per million inhabitants</td>
<td>3. Tertiary education enrolment</td>
</tr>
<tr>
<td>4. International telephone calls – minute per inhabitant</td>
<td>4. Demand for telephone lines – percent satisfied</td>
</tr>
<tr>
<td>5. Fax machines – 1,000</td>
<td>5. Capacity of telephone lines</td>
</tr>
<tr>
<td>6. Cell phones per 100 persons</td>
<td>6. Telecommunications staff</td>
</tr>
<tr>
<td>7. Cost of international call per minute</td>
<td>7. Investment in telecommunications</td>
</tr>
<tr>
<td>8. Average cost of local calls</td>
<td></td>
</tr>
<tr>
<td>9. Telephone line capacity used</td>
<td></td>
</tr>
<tr>
<td>10. Investment in telecommunications</td>
<td></td>
</tr>
<tr>
<td>11. Telecommunications revenue as percent of GDP</td>
<td></td>
</tr>
</tbody>
</table>

Source: Industrial Management Institute, Tehran

The results of this analysis are presented in Table 3.7. Out of the eleven variables in the “IT growth” index, Iran scores unfavourably in cell phones, internet hosts, and fax machines. But in the cost of international calls and investment in telecommunications, Iran is ranked in the middle of the table. In the “IT potential” index, Iran scores higher than the average in investment in telecommunication and lowers in the six other variables.

Table 3.7: Growth and potential of IT in selected countries

<table>
<thead>
<tr>
<th>IT Growth Score</th>
<th>Ranking</th>
<th>IT potential</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>0.58</td>
<td>1</td>
<td>0.65</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.6</td>
<td>2</td>
<td>0.47</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.63</td>
<td>3</td>
<td>0.8</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.65</td>
<td>4</td>
<td>0.54</td>
</tr>
<tr>
<td>Canada</td>
<td>0.69</td>
<td>5</td>
<td>0.49</td>
</tr>
<tr>
<td>U.S.A</td>
<td>0.71</td>
<td>6</td>
<td>0.59</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.76</td>
<td>7</td>
<td>0.73</td>
</tr>
<tr>
<td>Italy</td>
<td>0.79</td>
<td>8</td>
<td>0.68</td>
</tr>
<tr>
<td>Austria</td>
<td>0.81</td>
<td>9</td>
<td>0.49</td>
</tr>
<tr>
<td>Iran</td>
<td>0.89</td>
<td>10</td>
<td>0.83</td>
</tr>
<tr>
<td>Chile</td>
<td>0.95</td>
<td>11</td>
<td>0.78</td>
</tr>
</tbody>
</table>

Source: Industrial Management Institute
3.10 PHYSICAL INFRASTRUCTURE

The level and sophistication of physical infrastructure in Iran has been evaluated and measured by comparing international averages. Research carried out at the industrial Management Institute in Tehran, 28 variables were selected (15 variables were collected by questionnaires and the rest by gathering hard data). The result of this exercise shows that Iran stands at 53rd place among the 54 countries selected. Countries like Hong Kong and South Africa have positive coefficients, meaning that the infrastructure environment in these countries is relatively good. On the other hand, countries like Taiwan, Malaysia, and Korea have neutral physical infrastructure standing in the middle of the list. Iran, India, Russia and some other countries have negative score for physical infrastructure, which means a comparative disadvantage for the business communities in these countries as compared to other surrounding countries.

A comparison of some of the main infrastructure-related variables between Iran and six other countries with a similar development level and other structural similarities is provided in Table 3.8, to provide a clearer picture of the competitive position of Iran.

<table>
<thead>
<tr>
<th></th>
<th>Kilometers of road per 1 million inhabitants</th>
<th>Telecommunications Staff (1,000 persons)</th>
<th>Cost of local flights (US$ per kilometer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iran</td>
<td>2,629</td>
<td>46.56</td>
<td>0.29</td>
</tr>
<tr>
<td>Taiwan</td>
<td>922</td>
<td>35.00</td>
<td>0.24</td>
</tr>
<tr>
<td>Malaysia</td>
<td>4,565</td>
<td>27.53</td>
<td>0.10</td>
</tr>
<tr>
<td>Vietnam</td>
<td>1,235</td>
<td>75.00</td>
<td>0.22</td>
</tr>
<tr>
<td>Turkey</td>
<td>6,088</td>
<td>73.81</td>
<td>0.30</td>
</tr>
<tr>
<td>Korea</td>
<td>1,831</td>
<td>66.59</td>
<td>0.41</td>
</tr>
<tr>
<td>Egypt</td>
<td>-</td>
<td>51.75</td>
<td>0.43</td>
</tr>
</tbody>
</table>

1 Imaniad, Morteza and Bakkak Ghotbi, "Position of IT Growth and IT Potential in Iran", Industrial Management Institute, Tehran, 2001, P.91
PART 2: STATUS OF SSIs IN IRAN

3.11 DEFINITIONS OF SSIs

Iran, with a history over seventy-year activities in modern economics and experiencing over fifty years in economic planning, is one of the major pioneers of developmental activities plus with the most ancient cultures of the world related to the small workshops. However, we lack an exact, comprehensive and clear definition which would imply the nature of small manufacturing businesses.¹

In the periods of Development Plannings of the country, the two factors of the employee numbers and capital smallness have been pinpointed as features of identifying the small manufacturing businesses and distinguishing them from large or medium businesses. These distinctions in the presented definitions have not implied any philosophical nature which would express qualitative significance in the industrial development of the country.

In the following, from among different and varied definitions which have been absolutely based on quantitative criteria to be authorized by governmental different organizations and institutes, we refer to five definitions effective in the fate of small businesses. Finally, we will refer to the definition presented by the major reliable source of Small Businesses recently developed in Iran.

3.11.1 CENTRAL BANK OF ISLAMIC REPUBLIC OF IRAN

The Central Bank, which supervises and monitors the foreign exchange credits opened to develop industrial plants through purchasing their required raw materials and machinery, has given its definition of the Small Businesses as those groups of workshops which have got staff totaling to 50 or less.² However, in the decade of 1990s, this definition has been changed and the term Small Businesses have been entitled to units which have employed 10 or less people and according to this mentioned definition, the workshops which have over 10 employees are termed as large businesses.³

²-Central Bank of Islamic Republic of Iran: Some views concerning the small industrial and agricultural designs/Economic Survey Department, Tehran 1980, P. 14-16
3.11.2 MINISTRY OF JIHAD CONSTRUCTION (MOJC)
This Ministry, as the administrator of Small Rural Businesses and Convertibility Businesses, has considered four quantitative criteria in its exclusive definition coming below:
- Small business has got at most 50 employees.
- The maximum capital required does not total more than Rls. 500,000,000 (approximately $ 65,000).
- The required electricity usage does not exceed 50 KV. In each unit.
- Surface measurement of each workshop does not exceed 600 square meters.

3.11.3 MINISTRY OF COOPERATION (MOC)
This Ministry, another administrator of small businesses and credit grantee for manufacturing cooperation, has taken into notice four criteria (specifications) coming below to qualify manufacturing workshops as small businesses.
- Maximum number of employees in each working shift is estimated to be 5. (At most 15)
- The business must be totally Iranian. (Owned one hundred per cent by Iranians)
- Management is not based on specialty.
- The products of these businesses are artistic free aspects.

3.11.4 BANK OF INDUSTRIES AND MINES
This Department, which has been the administrator of industrial credits of Iran's development plans, has given the following exclusive definition for small businesses: "Those industries, which have got as much capital as Rls. 500,000,000 (or approximately $ 65,000), are termed as Small Businesses."

3.11.5 MINISTRY OF INDUSTRIES
This ministry is the most major governmental administrator making policies regarding industrial developments and granting foreign exchanges (funds) and

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2-The Management of Small Business Credits, Quoted from Special Issue 'Nazer',No.1 The Goods Monitoring and Supervisory Organization, Tehran 1997, P. 11
development credits to industries. It has defined small businesses as those business organizations which have got from six to 29 employees.\textsuperscript{1}

The new law, which has probably affected small industries section more, is the law of founding the Small Industries Organization in March, 2001. The formation of this organization is the first process in improving the institutional capacity for the expansion and promotion of this section. Small Industries Organization is the only official agency to collect and arrange appropriate policies and related plans regarding growth promotion and the development in small industries in rural regions. The latest definition presented by the small industries organization is again based on quantitative criteria. Those enterprises whose labour force ranges from 1 to 49 employees are termed as SSIs.\textsuperscript{2}

3.12 STATISTICAL OVERVIEW OF SSIs IN IRAN

This section provides a series of tables and graphs indicating the current state of SSIs in Iran with regard to various important variables. As shown in Table 3.9, 93% of all businesses are small enterprises with 1-49 employees. Obviously, there is an imbalance between the large number of small enterprises and the marginal number of medium and large sized businesses. It may be noted that the absence of a reasonable number of medium and large-sized enterprises, which amounting to only 7% of the total number of enterprises, is negatively affecting Iran’s ability to produce for the export market. From an international perspective it has come to be recognized that medium sized businesses, with 50-249 employees, typically account for a relatively large share of a country’s exports, as they are more readily able to avail themselves of the technical expertise, manpower, marketing skills and financial resources to participate in international business.

<table>
<thead>
<tr>
<th>Employees</th>
<th>Employees</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-49</td>
<td>&lt;50</td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>61786</td>
<td>4567</td>
</tr>
<tr>
<td>Percent</td>
<td>93%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Source: Small Industry Organization

\textsuperscript{1}Ministry of Industries, “Eight Year Industrial Efforts”, 2000, P. 104
\textsuperscript{2}An Outline of Findings and Recommendations for Policy Making in Small Businesses (UNIDO)/Planning and Development Vice-presidency, Farvardin 2004, p. 3
Figure 3.1, however, shows considerable differences in productivity rates per size category for Iranian enterprises. The larger companies, although very small in number, have a relatively high productivity, because their high production levels allow them to benefit from economies of scale. It is also for this reason that these businesses are able to compete far more effectively in international markets. However, as explained above, their number is far too small for them to be able to make a significant contribution to exports.

Figure 3.1: Comparison of productivity rates between SSIs and LSEs

As shown Table 3.10, 45.4% of all manpower in the industrial sector is employed in businesses with more than 100 employees, and in particular by LSEs, which represent only 3.2% of all industrial enterprises. By international standards, these data suggest that the industrial SSI sector has a tremendous potential for growth in Iran.

<table>
<thead>
<tr>
<th>Category</th>
<th>1-5 Employees</th>
<th>6-9 Employees</th>
<th>10-49 Employees</th>
<th>50-99 Employees</th>
<th>&gt; 100 Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of firms</td>
<td>30%</td>
<td>22.5%</td>
<td>40.5%</td>
<td>3.8%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Number of employees</td>
<td>62,778</td>
<td>89,572</td>
<td>423,630</td>
<td>133,315</td>
<td>588,944</td>
</tr>
<tr>
<td>Percentage</td>
<td>4.8%</td>
<td>6.9%</td>
<td>32.6%</td>
<td>10.3%</td>
<td>45.4%</td>
</tr>
</tbody>
</table>

Source: Statistical Yearbook of Iran

1 Statistical Yearbook of Iran, 2003
Table 3.11: Total number of new small industrial firms

<table>
<thead>
<tr>
<th>Industrial License Obtained</th>
<th>Firms Establishment Certificate Obtained</th>
<th>Physical Growth 20%</th>
<th>Physical Growth 40% and Above</th>
<th>Physically Active Small Industrial Enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of firms (1-5)</td>
<td>1,735</td>
<td>97</td>
<td>375</td>
<td>272</td>
</tr>
<tr>
<td>No of employees</td>
<td>7,206</td>
<td>421</td>
<td>1,586</td>
<td>1,144</td>
</tr>
<tr>
<td>No of firms (6-9)</td>
<td>5,155</td>
<td>145</td>
<td>1,124</td>
<td>714</td>
</tr>
<tr>
<td>No of employees</td>
<td>36,518</td>
<td>1,062</td>
<td>8,590</td>
<td>5,443</td>
</tr>
<tr>
<td>No of firms (10-49)</td>
<td>27,930</td>
<td>592</td>
<td>6,936</td>
<td>4,224</td>
</tr>
<tr>
<td>No of employees</td>
<td>566,450</td>
<td>11,556</td>
<td>148,061</td>
<td>88,179</td>
</tr>
</tbody>
</table>

Source: Small Industry Organization, Tehran

Of the entrepreneurs who had received their licenses in 1997, 20% had still not yet started their business by the end of 2001; while of those who had obtained their licenses in 1998, 43.5% had not yet started operations by the end of 2001. The percentages of firms that had not yet become operational by the end of 2001 and...
obtained their licenses in 1999, 2000 and 2001 was 63%, 82% and 90% respectively. The “potential firms” mentioned in Figure 3.2 are firms that have developed their business activities but are in the process of obtaining their quality standards certificates for exporting their goods and/or waiting for the disbursement of loans for technology- and capacity improvement or expansion.

Figure 3.2: SSI start-ups and delays in becoming operational, 1997/98-2001/02

Data on the added value and productivity per class of enterprises is presented in Table 3.12. These show that micro and small enterprises with up to 49 employees had a share of 34% of total value added, whereas the share of medium-sized and large enterprises, which accounted for only 0.6% of all industrial enterprises, amounted to 66%.

Table 3.12: Characteristics of industrial SSIs by size category

<table>
<thead>
<tr>
<th>Businesses category</th>
<th>%Share of Value added</th>
<th>Businesses %</th>
<th>Employees %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small firms (1-49 employees)</td>
<td>34</td>
<td>93</td>
<td>54.6</td>
</tr>
<tr>
<td>Medium and large firms</td>
<td>66</td>
<td>7</td>
<td>45.4</td>
</tr>
</tbody>
</table>

Table 3.13 provides information about various trade and repair services, subdivided by rural and urban areas in Iran. As might be expected, urban business
predominates, accounting for 79% of retail and repair services and 91% for wholesale trade.

Table 3.13: Establishments engaged in trade and repair services by urban/rural

<table>
<thead>
<tr>
<th></th>
<th>Rural</th>
<th>Urban</th>
<th>Rural</th>
<th>Urban</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail sales and repair</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Services of personal and Household goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wholesale and Commission trade</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>%</td>
<td>21%</td>
<td>79%</td>
<td>9%</td>
<td>91%</td>
</tr>
</tbody>
</table>

Source: Small Industries Organization

3.13 BIRTHRATES AND BANKRUPTCIES

According to the industrial policy of 1993, industrial licenses can be obtained by anyone who has a business plan. As indicated above, however, the lack of supportive programmers and infrastructure facilities have resulted in a low growth and slow progress of business start-ups and a high percentage of bankruptcies.

In order to determine the rate of survival and deaths of small businesses the following analysis was made. In 1997 more than 10,260 nascent entrepreneurs received their business licenses. However, 3,039 (or more than 30%) of the nascent entrepreneurs turned in their licenses without having made use of them in December of that year. By 2001, only 4000 nascent entrepreneurs were still in possession of their licenses, although only about 10% of these nascent entrepreneurs had actually commenced their business activities by that date. A similar development was also found for license holders who received their licenses in 1998. However, from 1999 onwards the start of business activities and the rate of survival began to improve.

Figure 3.3: Survival rates of firms licensed in 1996
Chapter (III) The Macro Economic Environment and Status of SSIs in Iran

Figure 3.4: Survival rates of firms licensed in 1997

Figure 3.5: Survival rates of firms licensed in 1998

Figure 3.6: Survival rates of firms licensed in 1999
3.14 FINANCIAL STANDING OF SSIS

3.14.1 BANKING NETWORK AND VENTURE CAPITAL SOURCES FOR INDUSTRIAL SMES

3.14.1.1 Banking system

Until recently, banks in Iran were owned entirely by the government and operated within a control-oriented administrative regime. This scene is slowly changing, however. From the ten existing banks listed below, two are now private banks. In addition three private non-bank credit institutions have been licensed.

Alongside the formal banking system, free market sources of finance known as the “bazaar-e-azad” are very active. These include some government owned pension funds, which are organized as private enterprises governed by the Commerce Law. The bazaar-e-azad suppliers charge much higher rates, which are in the order of 35% as compared to bank rates ranging from 13-26%, depending on source, purpose and maturity terms of the loan in question.

3.14.1.2 Commercial and sector-specialized banks

The commercial banking system in Iran consists of five state-owned banks and one private bank owned by the Social Security Organization Investment Fund. The commercial banks provide an extensive network covering every corner of the country, which has expanded considerably over the past five years. In one of the more traditional banks the increase in the number of operating branches has been supplemented by a number of qualitative improvements, including the re-composition of the workforce through massive recruitment of university graduates. The commercial banks in Iran are listed in Box 3.1.

Box 3.1 Commercial Banks in Iran

<table>
<thead>
<tr>
<th>No.</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank Mellit</td>
</tr>
<tr>
<td>2</td>
<td>Bank Saderat</td>
</tr>
<tr>
<td>3</td>
<td>Bank Tejarat</td>
</tr>
<tr>
<td>4</td>
<td>Bank Mellat</td>
</tr>
<tr>
<td>5</td>
<td>Bank Sepah</td>
</tr>
</tbody>
</table>

1 An example is the Islamic Republic of Iran Broadcasting Organisation (IRIB) pension fund.
The banking system in Iran also includes four specialized sector-specific banks, which use their credits for special developmental purposes. These banks, all of which are state-owned, include:

- Bank Sanat va Maadan (Bank of Industry and Mines, BIM), which is known as the main source of credit for SSIs.
- Bank Towsae Saderat (Export Promotion Bank). This bank is the main source for export credits.
- Bank Maskan (Housing Bank). This bank is the main source for financing of housing projects.
- Bank Keshavarzi (Agriculture Bank). This bank is the main source of financing for agricultural projects.

Figure 3.7 illustrates the ongoing trend of the expansion of the Iranian banking network. Table 3.14 shows the number of bank branches in the provinces with heavier industrial enterprise concentration and more active business centers. It should be noted that there is not much consistency between the number of bank branches and SSIs. In fact, the concentration of SSIs does not seem to be a determining factor in the expansion of bank branches in the country.
Table 3.14: Provincial distribution of commercial and specialized banks

<table>
<thead>
<tr>
<th>Provinces</th>
<th>Bank Meli</th>
<th>Bank Saderat</th>
<th>Bank Tejarat</th>
<th>Bank Mellat</th>
<th>Bank Sepah</th>
<th>Specialized Bank</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tehran</td>
<td>631</td>
<td>618</td>
<td>477</td>
<td>421</td>
<td>299</td>
<td>395</td>
<td>2,841</td>
</tr>
<tr>
<td>Khorsan</td>
<td>274</td>
<td>288</td>
<td>171</td>
<td>329</td>
<td>142</td>
<td>337</td>
<td>1,541</td>
</tr>
<tr>
<td>Isfahan</td>
<td>227</td>
<td>249</td>
<td>141</td>
<td>164</td>
<td>147</td>
<td>285</td>
<td>1,213</td>
</tr>
<tr>
<td>Fars</td>
<td>194</td>
<td>193</td>
<td>112</td>
<td>156</td>
<td>80</td>
<td>230</td>
<td>965</td>
</tr>
<tr>
<td>Khuzestan</td>
<td>172</td>
<td>263</td>
<td>128</td>
<td>92</td>
<td>69</td>
<td>192</td>
<td>916</td>
</tr>
<tr>
<td>E. Azerbeijan</td>
<td>142</td>
<td>131</td>
<td>74</td>
<td>93</td>
<td>92</td>
<td>174</td>
<td>706</td>
</tr>
<tr>
<td>Mazandaran</td>
<td>126</td>
<td>143</td>
<td>82</td>
<td>101</td>
<td>56</td>
<td>189</td>
<td>687</td>
</tr>
<tr>
<td>Gilan</td>
<td>128</td>
<td>135</td>
<td>76</td>
<td>79</td>
<td>52</td>
<td>148</td>
<td>618</td>
</tr>
<tr>
<td>W. Azerbeijan</td>
<td>93</td>
<td>58</td>
<td>81</td>
<td>105</td>
<td>52</td>
<td>120</td>
<td>509</td>
</tr>
</tbody>
</table>

Source: Kharazmi Management Institute of Bank Saderat Iran.

3.14.1.3 Private Banks and near-banks

Although private banks are new to the post-revolution banking system of Iran, the institution of private banking is not new to the country. The first bank founded in Iran over a century ago was a private foreign owned bank. The government has recently inaugurated the new era of private banking in the country by changing the status of a state-owned bank (Bank Refah) to a private bank, and licensing two private banks. Three near-bank credit institutions have also been established, one of which focuses specifically on entrepreneurs. These private banks and near-banks are listed in Box 3.2 below:

Box 3.2: Private Banks and near-banks

**Banks:**
- Refah
- Parsian
- Eghtesad Novin

**Near-banks:**
- Bonyad
- Towsee Sakhteman
- Kar Aforinan
3.14.1.4 Bank of Industry and Mines (BIM)
Among the sector-specific banks, the Bank of Industry and Mines requires specific attention as it is the main provider of funds for SSI start-up and expansion projects. The Bank’s present mission is to encourage and promote investment in the establishment and expansion of industrial, mining and high-tech enterprises and their support services through loans and joint ventures. It is a development and investment bank, which is managed as a profit-maximizing commercial enterprise. The bank’s clients consist of two groups: Firms owned and or controlled by the bank, and public or private firms. In both cases the majority of client firms are industrial SSIs. However, the scope of the bank’s activities is not limited to small firms only.

BIM is an exception among Iran’s banks in that all of its operations are concentrated in Tehran, as it does not run any provincial or other type of outreach branches. It serves distance customers through a network of 15 provincial representative offices, which act more as liaison offices. To satisfy the increasing needs of industrial firms located outside Tehran, the Bank now intends to open provincial branches.

Despite its broad mission BIM is generally known as a small industry bank, even though its performance with regard to the promotion of small business is not very impressive. A bird’s eye view at the Bank’s financing activities reveals the following:

- **Number of Loans:** In the past 21 years, i.e. between the years 1980/81-2001/02, it has approved (but not necessarily disbursed) 1,814 loans for large-scale enterprises and 3,730 loans for small firms. The actual number of loans granted during the Bank’s 45-year history is 2,250. In addition it has created 291 manufacturing and mining enterprises through direct or joint investments.

- **Loan Ceilings** are formally up to two-thirds of the total amount of investment needed, but in practice it generally does not exceed half of that amount.

- **Profit (Interest) Rates** on most of loans to industrial SSI mount to 17%. This is a relatively low rate as compared to regular commercial loans, which run at 25%.

- **Minimum Value of Collaterals:** Generally 150% the amount of the approved loan.

3.14.1.5 Other sources of venture capital for SSIs
Currently, the main sources of venture capital for SSIs at affordable rates are budget-directed funds channeled through Bank of Industry and Mines and other banks.

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Other sources include the Presidential special high-tech venture fund, IDRO's venture fund, and bank loans other than budget-directed ones, private banks, investment companies, free market venture capital and finally love money. None of these sources, however, are of much help to SSIs. The Presidential Fund, which seems to have been short-lived, was meant for and limited to high-tech ventures. Commercial loans of state or private banks and near banks are too costly to be financially affordable for SSIs. Even the subsidized rate of the Bank of Industry and Mines seems to be too high for many potential entrepreneurs. The available information on the birth rate of small firms in Iran does not permit a meaningful comparison of the Iranian situation with the rest of the world. Nevertheless the actual increase in the number of small firms with 10-49 employees between the two industrial census of 1996 and 1998 is to some extent revealing. During these two years there has been a total growth of 831 in the population of these firms (from 10938 to 11759), implying a 4% annual increase. Taking into account the annual number of new job seekers in Iran (some 800,000) we feel that this rate is rather low as it implies annual addition of some 8000 new industrial jobs in this category of firms. This seemingly low birth rate, inter alia, points to the unfavourable conditions for investment, among which the cost of capital could be a prime factor.

Love-money (money from family members or charitable individual loans) has traditionally been a viable source of micro-loans for some businesses ventures, but no measure is available to define the extent to which this source is used today. It is, however, safe to assume that in economies inflected with a high inflation rate this source will be less and less readily available.

3.14.2 PLANNED AND ONGOING REFORMS AND CHALLENGES OF THE BANKING SYSTEM

Critics often allude to the present inefficiencies in the banking system due to the government's ownership of the banks. Another source of complaints regarding the banking system refers to lack of flexibility and transparency of the system. The Iranian

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1 The two sets of data have been reported in the years 1997/98 and 1999/2000 respectively by the Statistical Centre of Iran: Industrial Census Project of 1997: the census results of industrial workshops with 10-49 employees and Industrial Census Project of 1997: the census results of industrial workshops with more than 10 employees. The average number of employees of these firms is 18 according to the 1997 data.

2 The high rate of interest implies high inflation. These two rates are certainly associated if not alike. In the circumstances, an interest-free love money loan with a term of 2-3 years means a gross loss of purchasing power of repaid money.
banking system is guided by Islamic finance principles. The 1983 law on interest-free banking provides fourteen allowable Islamic financial instruments for meeting loan applications. It is noteworthy that Islamic financial system allows considerable flexibility in financing arrangements. It also requires more detailed financial disclosure than non-Islamic systems as the system has a participatory nature, requiring client awareness of the banks’ risks, losses and gains. However, the current de facto banking system in Iran leaves much to be desired in terms of both flexibility and transparency.

The TFYP, ratified in 2001 has defined the major dimensions of the government’s banking reform policies. The changes foreseen include, inter alia, a considerable increase in the capitalization of the banks, the modernization and optimization of the banks’ operating systems, further licensing of near-bank credit institutions, and the licensing of onshore (Iranian owned) and offshore private banks in the Free Zones (including foreign owned banks, of which one has already been licensed in the Kish Free Zone).

Iran’s banking industry may therefore be on the verge of a challenging transition to a more market-oriented and competitive system. Since a comprehensive review of the needed and intended banking reforms is beyond the scope and purpose of this study, the following text will refer only to those changes that have important and direct consequences for the management and/or promotion of small businesses:

- Bank loans, including the budget-directed facilities, continue to be given primarily to the large, mainly public and semi-public, enterprises. With the intended changes in future, a more balanced distribution of business loans between small and large firms may be expected. As a step in this direction, the government has significantly increased the funds earmarked for small industry loans in the recent budget. Most of the newly allocated funds that have been put at disposal of the SIO are set aside for job creating venture loan projects.¹

- The real estate collateral that has hitherto been extensively used by Iran’s banks poses a serious problem for entrepreneurship development. The ongoing debate on the issue has led to the ratification of a new law by the Majlis, as a result of

¹ Information provided by the manager of the HRD and Entrepreneurship Division of the SIO. In 2001/02 the SIO received two appropriations totalling IR1,810 bn for the “30,000 job creation project” and for the partial financing of new ventures or SME expansion projects. This amount represents a manifold increase in SME financing as compared with the traditional BIM loans.
which the collateral requirement has been considerably relaxed. In theory this should have made it easier for small business to raise the required capital. In practice, however, except for certain small loans financed through and guaranteed by the SIO, the new law has not been fully implemented.¹

- An important change foreseen in the banking system is to revise the mission, and hence the strategies, of the BIM to make it more responsive to the financial, advisory and investment needs of SSIs and new entrepreneurs. Currently, more than 50% of the bank’s resources are used for the business firms directly owned or controlled by it. According to the anticipated changes, BIM would be relieved of its managerial responsibility for its current business holdings. Instead, it would focus on fulfilling its new mission. The road to these reforms may not be as smooth as policy makers envisage, however, as progress towards the revision of the bank’s charter has been very slow.²

- There is now more or less a general consensus among the observers of the banking system that the institutional and managerial capacity of the existing banks is not only inadequate to operate effectively in a more liberalized economy, but it is not even responsive to the day to day needs of the government and business community. Government’s dissatisfaction with the performance of banks has been echoed in the campaign launched by the Finance Minister an improvement in the productivity of the banks.³ Hence, an overhaul of the banks’ operation and management systems may soon become an urgent necessity. The minister has made this reform one of his top priorities, and has invited all bank managers to drafting their proposals for change.⁴

3.14.3 LENDING SCHEMES

The Bank of Industry and Mines, which is the major financial agency for SSIs, provides the only reliable information regarding the financial standing of such firms. An analysis of the allocation of the loans, other financial facilities and business services provided by this bank suggested that these services were provided primarily to

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⁴ Interview with the managing director of Bank Refah.
enterprises with a good market and growing sales. The bank's loan allocations for industrial SSIs in 1997/98-2000/01, disaggregated by sector, are shown in Table 3.15 below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Food</th>
<th>Textiles And Leather</th>
<th>Chemicals</th>
<th>Furniture and Paper</th>
<th>Non-Metallic Minerals</th>
<th>Metals</th>
<th>Electrical and Electronic</th>
<th>Services and Non-Mfg</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997/98</td>
<td>4641</td>
<td>6323</td>
<td>7572</td>
<td>708</td>
<td>2979</td>
<td>12672</td>
<td>1074</td>
<td>1259</td>
</tr>
<tr>
<td></td>
<td></td>
<td>11%</td>
<td>15%</td>
<td>18%</td>
<td>7%</td>
<td>12%</td>
<td>31%</td>
<td>3%</td>
</tr>
<tr>
<td>1998/99</td>
<td>4896</td>
<td>3221</td>
<td>10540</td>
<td>858</td>
<td>4696</td>
<td>10692</td>
<td>1700</td>
<td>300</td>
</tr>
<tr>
<td></td>
<td></td>
<td>13%</td>
<td>9%</td>
<td>28%</td>
<td>2%</td>
<td>13%</td>
<td>29%</td>
<td>4%</td>
</tr>
<tr>
<td>1999/00</td>
<td>17757</td>
<td>7559</td>
<td>23171</td>
<td>5061</td>
<td>3271</td>
<td>40282</td>
<td>1304</td>
<td>5205</td>
</tr>
<tr>
<td></td>
<td></td>
<td>17%</td>
<td>7%</td>
<td>22%</td>
<td>5%</td>
<td>3%</td>
<td>39%</td>
<td>1%</td>
</tr>
<tr>
<td>2000/01</td>
<td>30597</td>
<td>8253</td>
<td>24447</td>
<td>4984</td>
<td>10937</td>
<td>35707</td>
<td>2070</td>
<td>7310</td>
</tr>
<tr>
<td></td>
<td></td>
<td>24%</td>
<td>6%</td>
<td>20%</td>
<td>4%</td>
<td>9%</td>
<td>29%</td>
<td>2%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>27864</td>
<td>25356</td>
<td>65730</td>
<td>13611</td>
<td>23882</td>
<td>99356</td>
<td>6148</td>
<td>14074</td>
</tr>
<tr>
<td></td>
<td></td>
<td>19%</td>
<td>8%</td>
<td>21%</td>
<td>4%</td>
<td>8%</td>
<td>33%</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: Bank of Industry and Mines

The data in Table 3.15 show that the volume of loans offered by the Bank of Industry and Mines to SSIs has increased continuously since 1997/98. Most of the loans went to the metal working industries (33%), with the chemicals (21%) and food (19%) industries also receiving substantial shares. Importantly, moreover, 67% of the loans provided by the Bank of Industry and Mines went to small industrial enterprises (employing 10 to 49 workers), while a further 23% went to micro enterprises, as shown in Table 3.16. Medium sized businesses only received 10% of the total volume. As it is the bank’s policy to provide loans to profitable companies with a good market share, it follows that small sized businesses appear to be more profitable than medium sized companies.
Table 3.16: Allocation of loans by Bank of Industry and Mines to industrial SSIs by size of firm, 1997/98-2000/01

<table>
<thead>
<tr>
<th>Year</th>
<th>1-5 Workers</th>
<th>6-9 Workers</th>
<th>10-49 Workers</th>
<th>&lt;50 Workers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997/98</td>
<td>6.5%</td>
<td>13.5%</td>
<td>66%</td>
<td>14%</td>
</tr>
<tr>
<td>1998/99</td>
<td>8%</td>
<td>12%</td>
<td>67%</td>
<td>13%</td>
</tr>
<tr>
<td>1999/00</td>
<td>6%</td>
<td>12%</td>
<td>67%</td>
<td>15%</td>
</tr>
<tr>
<td>2000/01</td>
<td>7%</td>
<td>16%</td>
<td>67%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: Department of Small Industries; Ministry of Industry and Mines

Apart from the Bank of Industry and Mines, Industrial SSIs have access to several additional sources of finance, such as family and relatives, moneylenders, the Islamic Development Bank, foreign financial agencies, large enterprises (e.g. through sub-contracting agreements) and own savings.

3.14.4 PROFITABILITY

In the period immediately following the war with Iraq, between 1991/92-1995/96, Iran experienced a rapid growth in demand for various products and goods, which provided good growth opportunities for entrepreneurs. However, the large-scale industrial enterprises faced a shortage of capital for rebuilding their plant and machinery, which had been badly damaged during the war. Consequently, a significant share of production was taken over by SSIs, even though allocations of loans to small industrial projects were also limited. In addition, there was a shortage of foreign currency, which constrained the profitability of SSIs by preventing them from purchasing highly needed productive equipment.

The profitability of SSIs was also affected by their low quality standards, as the market was not prepared to accept products of low quality. Instead consumers continued to buy imported products, the more so as the government did not have a programme on technology development.

3.15 FORWARD AND BACKWARD LINKAGES OF LARGE-SCALE ENTERPRISES (LSES) WITH INDUSTRIAL SSIS

3.15.1 BACKWARD LINKAGES

The evolution of backward linkages between LSEs and industrial SSIs is a relatively recent phenomenon. After the war with Iraq, the automobile industry faced a huge
demand, but car manufacturers were not able to increase their production capacity to meet this demand due to a lack of working capital and other financial and technical problems. This prompted the automotive industry to begin to outsource some of its production to industrial SSIs in 1993. One of the bigger automotive companies, Iran-Khodro, started sub-contracting business to some 75 small- and 25 medium scale industrial enterprises. Since then there has been a steady increase in the outsourcing of component production to SSIs. The main reasons for this development may be summarized as follows:

- The growth of demand was much faster than the growth of the car manufacturers’ production capacities;
- The shortage of foreign currency was a major constraint preventing car manufacturers from purchasing car parts from abroad, and they therefore had to switch over to local production;
- The use of two-thirds of the existing production capacity for the manufacture of components, which could be manufactured elsewhere, constituted a major bottleneck for the large car manufacturing enterprises seeking to increase their output.

In this connection, it is important to note that the current production of the large state-owned car manufacturing enterprises amounts to some 300,000 units per year. This compares with a target of 450,000 for the year 2005/06 set in the Industrial Policy for Automotive Industries. Considering that there are currently 602 SSIs involved in making 78% of all components for 175,000 cars only, the scope for the further expansion of the role of SSIs in this sector remains considerable.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Iran-Khodro</td>
<td>11%</td>
<td>21%</td>
<td>36%</td>
<td>42%</td>
<td>78%</td>
</tr>
<tr>
<td>SAIPA Auto mfc</td>
<td>NA</td>
<td>9-10%</td>
<td>15%</td>
<td>32%</td>
<td>40%</td>
</tr>
<tr>
<td>Pars-Khoudro</td>
<td>5%</td>
<td>10%</td>
<td>22%</td>
<td>30%</td>
<td>34%</td>
</tr>
<tr>
<td>Khaver Desel</td>
<td>NA</td>
<td>9%</td>
<td>14%</td>
<td>24%</td>
<td>32%</td>
</tr>
</tbody>
</table>
A survey undertaken by the “Industries Development and Renewal Organization” (IDRO) revealed that approximately 2,000 industrial SSIs in Iran had a sufficient potential and capacity to become successfully involved as suppliers for LSEs in the automotive industry. This is consistent with the intended 50% increase in the production of cars from current levels by 2006, which will require considerable extra production capacity to be made available by industrial SSIs in the intervening period.

Extensive support for the increased development of sub-contracting and outsourcing practices between LSEs and SSIs will be provided by the newly established “Small Industry Organization” (SIO), although the effectiveness of these services may be constrained by a lack of complementary programmes and the inadequacies of the legal structure. Backward linkages between LSEs and industrial SSIs are also found in some other sectors of industry, as shown in Tables 3.19 and 3.20 below.

Table 3.19: Number of subcontracting activities between LSEs and SSIs in the automotive and electronics industries, 1990/91-2000/01

<table>
<thead>
<tr>
<th>Industries</th>
<th>1990/91</th>
<th>1995/96</th>
<th>2000/01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobile Industries</td>
<td>325</td>
<td>850</td>
<td>1420</td>
</tr>
<tr>
<td>Electronics (SHIRAZ Electronic Industries)</td>
<td>14</td>
<td>32</td>
<td>75</td>
</tr>
</tbody>
</table>

Table 3.20: Percent share of SME subcontractors in the manufacturing of components for selected industries, 1995/96-2000/01

<table>
<thead>
<tr>
<th>Industries</th>
<th>1995/96</th>
<th>2000/01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Heavy Industries</td>
<td>13</td>
<td>32</td>
</tr>
<tr>
<td>Truck Industries</td>
<td>23</td>
<td>69</td>
</tr>
<tr>
<td>Railway Industries</td>
<td>10</td>
<td>30</td>
</tr>
<tr>
<td>Machinery Industries</td>
<td>25</td>
<td>64 to 88</td>
</tr>
<tr>
<td>Oil and Petrochemical Industries</td>
<td>Less than 5</td>
<td>10</td>
</tr>
<tr>
<td>Home Appliance Industries</td>
<td>22</td>
<td>42</td>
</tr>
<tr>
<td>Others</td>
<td>10</td>
<td>25</td>
</tr>
</tbody>
</table>
3.15.2 FORWARD LINKAGES

Forward linkages between LSEs and industrial SSIs are not as well developed as backward linkages. Most of the forward linkages are related to industrial food processing and the metal, textile and wood (furniture) industries. Such forward linkages take essentially two forms: The distribution of goods manufactured by LSEs and the repair and maintenance of the LSEs’ plant and equipment. It is thus estimated that there are more than 450 medium sized food-Industry enterprises in Iran that have developed forward linkages with SSIs, and a similar number of LSEs which have established links with SSIs for activities related to product distribution and plant maintenance.

3.16 ENVIRONMENTAL ISSUES

The Third Five Year Plan (2000-2004) devotes a full chapter to the issue of environmental policies and states explicitly that all manufacturing units are obliged to take measures to conform their technical specifications with the environmental criteria set by the government on the basis of standards established by the World Health Organization (WHO). Expenditure for improvements to reduce the extent of pollution is in principle fully tax deductible. During the Third Plan, specific action took to reduce pollution levels in the cities of Tehran, Mashad, Tabriz, Ahwaz, Arak Shiraz and Isfahan. Fines imposed by local environmental offices on manufacturing enterprises for not complying with the standards will be used for environmental rehabilitation programmes.

The TFYP also provides for the relocation of some industries from urban to other areas. To that end, industrial product units have been categorized in three different levels: A, B and C. Each level indicates where selected manufacturing enterprises can be located. A-level industrial units must be located at a distance of at least 3 kilometers from the nearby city; B-level industrial units should be located 5 kilometers from the city, whereas C-level industries at a distance of at least 10 kilometers.

3.17 TECHNOLOGY LEVELS

Data restrictions prevent an accurate assessment of the technology levels of industrial SSIs in Iran. For the purposes of this study, available data on the share of investment in machinery and tools by small industrial enterprises have been used as a
proxy for the share of investment in technology development. These data, presented in Table 3.21, may serve as an indication of the technological standing of Iranian SSIs.

Table 3.21: Investment in machinery and equipment by small industrial enterprises as a share of total investment

<table>
<thead>
<tr>
<th>Year</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1997/98)</td>
<td>53%</td>
</tr>
<tr>
<td>(1998/99)</td>
<td>48%</td>
</tr>
<tr>
<td>(1999/00)</td>
<td>48%</td>
</tr>
<tr>
<td>(2000/01)</td>
<td>46%</td>
</tr>
<tr>
<td>(2001/02)</td>
<td>52%</td>
</tr>
</tbody>
</table>

The main obstacles to technology development are:

- A shortage of funds;
- The very lengthy process for allocation of loans;
- The high cost of imported technology (i.e. machinery and tools, know-how and R&D facilities);
- The low profitability of industrial SSIs in Iran, which restrains investment in technology modernization;
- Lack of knowledge of entrepreneurs regarding the importance of technology improvement on productivity and profitability;
- The absence of any particular programme or policy regarding technology upgrading in industrial SSIs, with the exception of ISO programmes.

3.18 GOVERNMENT POLICY TOWARDS SSIs

In most countries manufacturing and non-manufacturing SSIs are supported by a number of specific policies and programmes. There are various policies that can have an impact on SSIs, such as industrial policy, labour policy, financial and fiscal policy, trade policy, education and training programmes, and technology policy. This section will deal with these policies and programmes as they are implemented in Iran. The main objective is to make an inventory of these policies and programmes, and to identify any unfavourable effects their application may have on SSI development in Iran. The
resulting insights into the prevailing situation will facilitate the formulation of appropriate and practical recommendations for improvement.

3.18.1 POLICY OBJECTIVES AND STRATEGIES FOR SSI DEVELOPMENT

The policy objectives of the Government of Iran with regard to the development of the industrial sector and industrial SSIs, and the strategies to be adopted to achieve these objectives, can be derived from the national goals and policies set in the Economic, Social and Cultural Development Plans adopted during the past two decades. These are summarized below.


The most important industrial development goals of this First Five-Year Plan (FFYP) were:

- Increasing per capita production;
- Developing non-oil exports;
- Expanding productive employment;
- Securing minimum levels of basic needs; and
- Restructuring the manufacturing capacity destroyed during the war.

The measures adopted by the Government to achieve these goals were:

- Encouraging private sector investment in export-oriented industries;
- Transferring public industries to the private sector;
- Selecting appropriate technology with minimum foreign exchange costs and without relying on international monopolies; and
- Improving the structure of industrial production through a continuous increase in the production of capital goods and increased reliance on internal resources.

Support to SSIs in general, and to labour-intensive industrial SSIs in particular, was specifically mentioned in the Plan. In addition, mention was made of the need to establish and develop specific industrial activities, especially in rural areas, by strengthening production capabilities and increasing competitiveness.

The industrial development goals and instruments of the FFYP were broadly retained in this Second Five-Year Plan (SFYP). In addition to these broad goals, the SFYP called for special attention to be paid to the development of industrial SSIs, e.g. by making financial facilities available in support of rural and handicraft industries.

3.18.1.3 The Third Economic, Social and Cultural Development Plan 1999/00-2003/04

The most important goals of the current TFYP with regard to the industrial sector are:

- Upgrading productivity and the efficiency of human resources;
- Upgrading technical and professional know-how, and the skill-level of the labour force;
- Reducing governmental monopolies and promoting competitive economic activities;
- Providing facilities to investors of small industries; and
- Promoting non-oil exports and exports of technical and engineering services;
- Reinforcing electrical industries by co-ordinating investments.

To achieve these goals, the Government has adopted the following policies:

- Reorganizing the training of labour in order to increase technical and professional competencies and thereby achieve increased levels of productivity and efficiency;
- Providing facilities for new industrial SSIs, especially in isolated locations lacking raw materials and intermediate goods, with the objective of creating employment in underdeveloped areas;
- Providing funds to the Bank of Industry and Mines for setting up credit lines for industrial SSIs;
- Allowing tax exemptions in less developed areas in order to create employment; and

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Revision of customs tariffs, taxes and other dues in order to encourage non-oil exports.

The government also decided to allocate part of its oil revenues and other incomes to achieve its target on promoting job-creation, and to provide sound financial and non-financial facilities for implementing programmes for employment generation and enhancing the export activities of SSIs.

3.18.2 INDUSTRIAL POLICY

During recent years, the industrial sector has been faced with many problems as identified below:

- High foreign currency costs because of the dependence of industrial enterprises on imports of capital goods, raw material and essential components;
- Difficulties in securing financial resources to provide the foreign currency needed for the purchase of raw materials and components;
- The Government’s policy of levying various taxes and duties from industrial enterprises in order to support social organizations, such as sports clubs and training colleges, etc.;
- Low industrial exports caused by various restrictive regulations and the inadequate quality of the merchandise;
- Low levels of innovative activities and insufficient finance for carrying out R&D; and
- The continued priority given to public-sector industrial enterprises for financial and nonfinancial facilities, and the consequent shortage of these facilities for the private sector.

According to the TFYP, the government’s industrial policies to address these problems are as follows:

- Attracting domestic and foreign investments;
- Adjusting policies for expanding the share of industrial SSIs in GDP, inter alia by promoting women entrepreneurship;
• Supporting all forms of employment-generating activities, including self-employment, entrepreneurial activities and group business activities in rural areas;

• Developing domestic financial resources to increase investments by introducing savings incentives and promoting small investments;

• Developing the cooperative sector and encouraging entrepreneurial activities in it by introducing effective and sound support systems; and

• Simplifying the regulatory framework for investments in the manufacturing sector;

In addition, the following measures have been taken:

• The maximum tax rates have been reduced from 60% to 25% in all business sectors, including manufacturing, services, trade, etc.;

• A new tax policy which prohibits government organizations and agencies from levying any additional taxes or duties, such as municipal corporate taxes, on the manufacturing sector;

• Foreign exchange facilities have been granted to the private sector;

• The access of the private sector to loans and other financial facilities has been increased through a simplification of the banking system;

• Investors in under-developed areas have been exempted from various official levies and duties, and been offered a partial reimbursement of the cost of electricity and water for industrial, agricultural and mining use for the first five years of a company’s operation;

• The tax rate applied to firms in underdeveloped areas has been reduced by more than 30% as compared to other areas;

• Publicly owned industries have been restructured on the basis of detailed plans for modifying machinery and equipment, and for achieving overall improvements of the financial structure, manpower, management and technology;

• Facilities have been granted for upgrading the skill level of labour employed in industrial sector; and
The “Small Industries Organization” has been established to support small units in the private sector in less developed areas and increase industrial employment.

3.18.3 TRADE POLICIES AFFECTING SSIs

The prevailing trade policies are related to all industrial sectors, irrespective the size of the businesses. The manner in which they affect SSIs is described below.

3.18.3.1 Tax incentives

Tax incentives are part of a set of direct tax regulations, which are implemented to encourage industrial investment, restructuring and the development of the export potential of existing industrial SSIs.

3.18.3.2 Customs incentives

Customs incentives include provisions for special customs facilities in order to protect domestic manufacturing industries against imports and to create incentives to export industrial goods. The support is rendered by setting appropriate duties or duty exemptions, and in that way to try to enable domestically produced industrial goods to compete with imported products in the domestic market. Some of the industry-related customs incentives offered by the Government include:

- Imports of machinery undertaken with the approval of the Ministry of Industry and Mines are exempt from customs duties and commercial profit duties;
- All manufacturing enterprise, both LSEs and SSIs, which may need to import raw materials, machines, components, engineering instruments, etc. for enhancing their export activities are exempted from any import duties and taxes on these goods.

3.18.3.3 Financial incentives

In order to reduce investment risks in the industrial sector, and simultaneously to reduce manufacturing costs and enhance the financial standing of industrial SSIs, the following financial incentives have been put in place:

- A lowering of interest rates for the industrial sector as against to the service sector;
- Special discounts on credit facilities and the provision of specific assurances for investments in preferential industrial fields; and
• The granting of special financial facilities to increase the capacity of export-oriented industries.

3.18.3.4 Foreign investment incentives

The aim of attracting foreign investments is to establish innovative production units, generate employment, upgrade the technical and scientific capacities of the labour force, upgrade the quality of industrial products, and access export markets. This will stimulate the growth of national income and reconstruction of the country.

The main government incentives provided in this connection include:

• Foreign investment in industrial sectors is granted the same benefits regarding tax exemptions and other financial incentives as provided to local investors; and
• The adoption of new foreign direct investment (FDI) rules, which were approved by Parliament in November 2001, and subsequently ratified by the Supreme Guardian Council.

3.19 SOME OF THE ROOT CAUSES FOR THE RELATIVE UNDERDEVELOPMENT OF SSIs

3.19.1 ABSENCE OF SUPPORTIVE GOVERNMENT POLICIES

After discussing the broad policy issues governing SSIs and the support systems required by them, a brief analysis addressing some of the fundamental causes of their shortcomings is in order. Such an analysis will help to set the stage for a long-term approach to SSI policy and the institutional arrangements for supporting and monitoring the development of SSIs in Iran.

In recent years many countries have recognized the importance SSIs in the overall national economic and social development processes. There has been a progressive trend toward the investment of financial and intellectual capital to exploit the potential of SSIs, both in the advanced economies and in the newly industrialized world. One of the consequences of such investments has been the growing interest of large industrial companies in the use of small firms, through sub-contracting arrangements, for shaping more flexible and less expensive supply chains.

In Iran, however, government policy toward SSIs until very recently was marked by a lack of awareness of their potential contribution to national economic
development. Economic planners and policy makers in Iran have traditionally looked at SSIs in general and industrial SSIs in particular, as peripheral institutions whose economic contributions are limited to creating low-tech jobs. This is indicated by the following observations:

- The birth rate of small firms in the country has historically not been a matter of great concern for the government, as underlined by the absence of credible statistics on the birth and death of these firms.

- There is no institutional arrangement for monitoring entrepreneurship development activities. It is noteworthy that advanced economies, recognizing the innovative potential of small firms, have established effective monitoring systems to inform their policy decisions on entrepreneurship issues. The Global Entrepreneurship Monitor (GEM), which produces an annual report, is a good example of the importance attached to the economic role of smaller ventures.¹

- The development of private sector venture capital, a financial instrument for channeling resources to entrepreneurial talents and helping them to put their ideas into action, has not drawn much attention in Iranian industrial policy circles. At present the main source of capital available to entrepreneurs are budget-directed facilities. This channel has serious limitations as regards effective entrepreneurship development, particularly for helping small entrepreneurial ventures.

- None of the planning documents produced in the past twenty years give appropriate weight to SSIs and entrepreneurship development. No policy provisions could be found in those documents for the establishments of SSI-specific support institutions provide training, consulting, networking, and incubation and research services.

- One of the most important signs, and at the same time grave consequences, of the inattention to SSIs and their entrepreneurship potentials is the absence of specific intellectual support systems for small industries. Such support institutions are particularly thin on the ground in SSI concentrations outside Tehran. Even in Tehran, where most of the general management training,

¹ See GEM Reports, 1999 to 2002.
consulting and research institutes are located, SSIs are heavily under-represented among the clients of these institutions.¹

- Except for one recent PhD graduate who wrote a dissertation on "entrepreneurship" and has now joined the academic community, there is no trained faculty in this vital area.
- None of the educational programmes offered by universities at present, except for a new package to be offered as part of an MBA course, include small business management or entrepreneurship in their curriculum.

All in all, industrial SSIs in Iran have not developed to their full potential because of the lack of attention and support that they have received. This study has found that the problem is basically rooted in the prevalence of an implicit industrial development paradigm in Iran, according to which the road to national economic development goes through large-scale projects, mostly leading to large-scale public enterprises. The weakness of this paradigm is increasingly being recognized, inter alia by the President of Iran Chamber of Commerce, Industry and Mines, who has spoken out against Iran's traditional over-reliance on large-scale industrial undertakings, mostly at the expense of the investment needed to boost the potential economic contributions of smaller firms. To put an effective policy for development of SSIs in place, however, the old industrial paradigm has to be replaced with a more balanced approach.

The situation is now fortunately changing. For the first time during the half century of economic development planning in the country, a government agency has recently been established – the Small Industries Organization (SIO) of the Ministry of Industry and Mines – with the proper administrative rank and authority to act effectively as a focal organization for policy development and reforms in this area. At present the agency's most immediate and pressing mandate is to make an effective contribution to the government's job creation crusade. This short-term assignment is understandable in view of the present high unemployment rates, particularly among the country's youth, but the agency's authorities are well versed with fresh ideas and do realize the importance of a multidimensional SSI development policy. They are

² This refers to the newly instituted entrepreneurship package included in the MBA programme of Sharif University;
cognizant of the fact that their long-term mission goes far beyond job creation alone, and that they should help to create a business environment to assure the self-sustaining improvement of the competence of Iranian SSIs to enable them to integrate themselves into the global economy.

3.19.2 ACADEMIC DISINTEREST

Another root of the underdevelopment of Iranian SSIs can be traced to the lack of interest of Iranian universities and other research centres in issues related to small business and entrepreneurship. Academia, in modern world, is one of the most influential sources of new ideas. Academic research in the advanced economies informs public and business policies and inspires corrective actions. To the extent that academic interests and findings in an area of human endeavour could influence the directions taken by public and private organizations in that area, academic disinterest in any field of inquiry could also adversely affect the potential growth and development of that field. In this age of knowledge economy, therefore, the directions of academic research could have far reaching consequences for the performance of national economies. The study of SSIs and entrepreneurship in Iranian universities is a case in point. While the number of published academic materials throughout the world in the field of entrepreneurship alone has now exceeded some 35,000 titles, the corresponding figure for Iran does not exceed a few dozen.¹

¹ The information presented here is based on extensive interviews with the Director and departmental managers of the SIO.