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THE EVOLUTION OF FOREIGN DIRECT INVESTMENT IN IRAN: DETERMINANTS AND ECONOMIC IMPACT

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Abstract This paper examines the historical context and contemporary research on foreign direct investment (FDI) in Iran, a topic with limited prior research. The study aims to fill this gap by highlighting FDI critical significance for the country's economic development. The study provides a comprehensive overview of the evolution of FDI in Iran, tracing key milestones and shifts in investment patterns over time, particularly in response to changing political, economic, and social landscapes. Additionally, it reviews existing literature on the determinants and effects of FDI in the Iranian economy, focusing on crucial factors such as political stability, regulatory frameworks, and market potential. The study reveals how fluctuations in FDI can be attributed to both internal dynamics, such as government policies and economic conditions, and external influences, including international relations and global market trends. By synthesizing previous research, this paper aims to illuminate the complexities surrounding FDI in Iran, offering insights into its impact on economic growth, job creation, and technological advancement. Furthermore, the findings underscore strategic policy implications for enhancing investment attractiveness, advocating for reforms that promote a more favorable investment climate. Ultimately, this article contributes to a deeper understanding of FDI's role in shaping Iran's economic trajectory and its implications for the broader Middle Eastern region.

Keywords: Foreign Direct Investment, FDI, Iran, Middle East

İRAN'DA DOĞRUDAN YABANCI YATIRIMIN EVRİMİ: BELİRLEYİCİLER VE EKONOMİK ETKİ

Öz Bu makale, İran'daki doğrudan yabancı yatırım (FDI) ile ilgili tarihsel bağlamı ve güncel araştırmaları inceleyerek, ülkenin ekonomik gelişimi için kritik önemini vurgulamaktadır. Çalışma, İran'daki FDI'nin evrimine ilişkin kapsamlı bir genel bakış sunarak, özellikle değişen politik, ekonomik ve sosyal manzaralara yanıt olarak zaman içinde yatırım modellerindeki önemli kilometre taşlarını ve değişimleri izlemektedir. Ek olarak, İran ekonomisindeki FDI'nin belirleyicileri ve etkileriyle ilgili mevcut literatürü gözden geçirerek, politik istikrar, düzenleyici çerçeveler ve piyasa potansiyeli gibi önemli faktörlere odaklanmaktadır. Çalışma, FDI'deki dalgalanmaların hem hükümet politikaları ve ekonomik koşullar gibi iç dinamiklere hem de uluslararası ilişkiler ve küresel piyasa eğilimleri gibi dış etkilere nasıl atfedilebileceğini ortaya koymaktadır. Bu makale, önceki araştırmaları sentezleyerek, İran'daki FDI'yi çevreleyen karmaşıklıkları aydınlatmayı, ekonomik büyüme, iş yaratma ve teknolojik ilerleme üzerindeki etkisine ilişkin içgörüler sunmayı amaçlamaktadır. Dahası, bulgular, daha elverişli bir yatırım ortamını teşvik eden reformları savunarak yatırım çekiciliğini artırmak için stratejik politika çıkarımlarının altını çizmektedir. Sonuç olarak bu makale, doğrudan yabancı yatırımların İran'ın ekonomik gidişatını şekillendirmedeki rolünün ve daha geniş Orta Doğu bölgesi üzerindeki etkilerinin daha derin bir şekilde anlaşılmasına katkıda bulunmaktadır.

Anahtar Kelimeler: Yabancı Doğrudan Yatırım, FDI, İran, Orta Doğu

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INTRODUCTION

The Islamic Republic of Iran has been a question mark for many foreign investors for many years. There are many tempting incentives for considering entering the Iranian market, on the other hand, there are serious challenges regarding governance and international relations of the country that worries investors. When Iran's foreign direct investment (FDI) is compared with its neighbors and other countries with similar characteristics, it is easy to note that Iran's FDI inflow is not where it should be. In fact, the European Monetary Institute estimates that the average foreign investment attraction of countries that have similar characteristics as Iran should be around $ 5.7 billion, while Iran has not been able to attract even one-fifth of this amount in recent years (Abbasi, 2004). According to the World Investment Report in 2020, the amount of foreign direct investment into Iran during 2019 was estimated to be around 1 billion and 508 million dollars. This amount was 2 billion and 373 million dollars in 2018 which indicates a 36.4 % decrease in just one year. According to the report, in 2019, 1540 billion dollars of foreign direct investment was attracted in the world, of which Iran's share is equal to just 0.09 percent (UNCTAD, 2020). Comparing FDI inflows of Iran with one its neighbor countries, Türkiye, it is evident that Iran is way behind in this regard. In 2019, Türkiye inflow FDI was reported to be around 9.51 billion dollar, 1.25 % of GDP (Udemba, 2020).

FDI is considered as a powerful catalyst for economic progress in developing countries (Herzer, 2012). It serves as a significant source of capital, technology, and managerial expertise, which are often scarce resources in such countries (De Mello Jr, 1997). By injecting fresh capital, FDI can stimulate investment, create jobs, and boost economic growth (Loungani & Razin, 2001). In addition, FDI can facilitate the entry of international companies into new markets, where diverse boards can offer valuable insights and perspectives on local customs, regulations, and consumer preferences (Amiri et al., 2022). Iran, like many developing nations, is no expectation and could significantly benefit from increased foreign direct investment (FDI). The country's economy, particularly its oil industry, a cornerstone of its economic structure, faces pressing challenges that could be eased through strategic foreign investment (Nejati & Bahmani, 2020; Özeren et al., 2023). Lack of modern technology and use of old machinery for production, the high population growth rate in the mid-80s, the cost of rebuilding the devastation caused by eight years of war with Iraq and, keeping pace with the accelerating economic growth in the region and South Asia are just a few reasons that makes Iran thirst for foreign investment (Kiani & Kiomers, 2006). However, there are many obstacles that prevented the proper inflow of FDI into the country. Some of these challenges that can be mentioned are exchange rate opacity, the validity of the law of immovable property ownership, inconsistency with the current conditions of the domestic and global economy, unconstitutionality, limited fields of activity for investors, Extensive inclusion of foreign capital, and the commitment of capital inflows (Daliri, 2021).

This paper aims to shed light on the past and present situation of Iran inward FDI, while reviews some of the previous research that had been done regarding the effects and determinants of Iran FDI flow. This research fills a significant gap in the literature by examining the determinants and effects of FDI in Iran, a topic with limited prior research. By examining the factors influencing FDI inflows and their impact on the Iranian economy, this study offers valuable insights for policymakers and researchers alike. It contributes to a better understanding of the complex dynamics of FDI in a unique economic context. In addition, suggestions for future research topics are provided at the end of the paper.

The structure of the paper is as follows. First, a brief history of foreign investment in Iran and its evolution is explained. In addition to that, the recent fluctuations of Iran FDI, based on the UNTCAD database, over the past two decades is examined. Next, previous studies and their findings regarding the effect of FDI on the country and factors affecting it are discussed. Finally, a conclusion with suggestions for future studies is provided.

EVOLUTION OF FOREIGN DIRECT INVESTMENT IN IRAN

Definition

International Monetary Fund (IMF) defines FDI as a kind of international investment that is made with the aim of gaining sustainable resources in a country other than the investor's homeland with the purpose of playing an effective role in the management of the relevant enterprise (IMF, 2003). The United Nations Conference on Research and Development (UNCTAD) defines FDI as "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)" (UNCTAD, 2007). These definitions highlight the strategic nature of FDI, emphasizing that it involves not just financial investment but also a commitment to establishing operational control and a sustained partnership with the local enterprise. This relationship often facilitates the transfer of technology, skills, and managerial expertise, thereby contributing to the economic growth of the host country while also aligning with the investor's long-term strategic goals (Loungani & Razin, 2001). In other words, this type of investment is not merely about transferring capital; it is aimed at establishing a significant and lasting presence in the foreign market, enabling the investor to play an effective role in the management and operations of the relevant enterprise.

History of Foreign Investment in Iran

Hadi Zanvar (2000), in his book, examines the history of foreign investment in Iran and how it evolved from its beginning until the year 2002. He defines four eras and discusses foreign investment in Iran for each era.

The first era discusses the foreign direct investment in Iran from the beginning until 1956. Before 1931, there were no special regulations for foreign investment in Iran, and one of the features of this period was the granting of exclusive privileges to citizens of foreign governments to plunder the national wealth of the country. During this period, the powerful Russian and British governments took advantage of weakness in the central government and using their military power and other necessary levers concluded unilateral contracts that gained profit from investing in public facilities and property of the country.

The second era starts in 1950 and ends before the Islamic Revolution in 1978. In 1951, the nationalization of the oil industry occurs in Iran, which resulted in raising tension between Iran and the United Kingdom and its ally, the United States. As a result of this, foreign companies refused to register their companies in Iran. This trend continued until 1955 when, for the first time, the law on attracting and protecting foreign investment was passed in Iran. The law guaranteed foreign investment and provided special facilities for investors. With the passage of the law and the adoption of appropriate measures, including the creation of investment security, the volume of foreign investment in Iran increased by 44% per year from 3 million rials per year in 1957 to 6235 million rials per year in 1978. In the year 1978, the exchange rate for the dollar was 100 Rials (Jamaran News, 2020).

The third era is after the Islamic Revolution and deals with foreign direct investment between the years 1979 and 1993. This period coincides with the victory of the Islamic Revolution and the ratification of Article 85 of the Constitution of the Islamic Republic of Iran, according to which, regardless of its different interpretations, foreign direct investment in strategic industries, including oil, was prohibited. This important event, along with the decrease in the degree of economic security due to the war situation in the country and the expropriation of foreign companies, the existence of some legal obstacles to foreign investment activities, and the lack of appropriate implementation policies and programs, disagreement between authorities and decision-makers - whether or not to attract investment, which is, in fact, a kind of political risk on the part of investors - have drastically reduced the inflow of foreign direct investment. This process continued to the point where, just two years after the Islamic Revolution, the total volume of foreign investment entering the country dropped to zero. The only worth mentioning foreign investment between 1978 and 1993 was 12 billion Rials (45 million dollars) of capital, which was the investment by Japan in 1981. The estimated exchange rate for one dollar in 1981 was equal to 270 Rials (Jamaran News, 2020).

The fourth era and final era discuss the foreign direct investment in Iran after 1993. The beginning of this period is the turning point for foreign direct investment after the revolution. The need for capital to rebuild war-torn areas, the ban on foreign borrowing, and the lack of savings for investment led the Iranian government in early 1991 to seek appropriate ways to attract foreign direct investment. In this regard, in addition to passing laws in 1993, the government made many other efforts to attract foreign investment such as revisions of the exchange rate and establishing a floating exchange rate, revisions of the pricing policies of industrial goods and liberalizing prices, privatizing state-owned industries, creating free zones and encouraging foreign investment. As a result of these measures, after thirteen years, the first case (although small) of foreign direct investment in 1994 was made. In total, the entering capital to the country between 1993 to 2002 was around 295 million dollars. It should be noted that these policies were not completely successful, as a result, there was a return to a controlled currency system, a decline in the privatization movement, and a re-control of prices.

A subsidiary of Iran's Ministry of Economic Affairs and Finance by the name "The Organization for Investment, Economic & Technical Assistance of Iran (OIETAI)" provides past data regarding foreign investment in Iran. In addition, Word Bank Data provides data regarding the FDI flow of Iran. Table.1 illustrate the net inflows of foreign direct investment and its percentage of GDP for Iran.

Table 1. The Net Inflow of Foreign Direct Investment for Iran during 1970-2023 in Million Dollars
Source: Word Bank Group

Year	FDI net inflows	% of GDP	Year	FDI net inflows	% of GDP
1970	28	0.26	1997	53	0.05
1971	65.2	0.47	1998	24	0.02
1972	91.2	0.53	1999	35	0.03
1973	561.5	2.07	2000	39	0.04
1974	323.5	0.70	2001	408.1	0.32
1975	494.4	0.95	2002	3519.4	2.74
1976	-101.5	-0.15	2003	2877.5	1.87
1977	345.7	0.43	2004	3037.3	1.60
1978	909	1.17	2005	2889.2	1.28
1979	164.3	0.18	2006	2317.5	0.87
1980	80.9	0.09	2007	2017.8	0.58
1981	28.2	0.03	2008	1980	0.48
1982	-136.0	-0.11	2009	2983.4	0.72
1983	-78.5	-0.05	2010	3649	0.75
1984	42.7	0.03	2011	4276.7	0.68
1985	-38.1	-0.02	2012	4661.7	0.72
1986	-112.4	-0.05	2013	3049.9	0.62
1987	-307.6	-0.23	2014	2105.5	0.46
1988	60.5	0.05	2015	2050	0.50

1989	-19.4	-0.02	2016	3372	0.74
1990	-361.9	-0.29	2017	5019	1.03
1991	22.5	0.00	2018	2373	0.72
1992	8.5	0.00	2019	1508	0.53
1993	207.5	0.33	2020	1342	0.56
1994	2	0.00	2021	1425	0.40
1995	17	0.02	2022	1500	0.36
1996	26	0.02	2023	1422.3	0.35

During 2001-2005, the second government of Mohamad Khatami, a reformist government with a de-escalation policy, focused on gaining the trust and confidence of foreign investors which resulted in a slow but steady increase in FDI inflow. This trend was followed by the next government while the tension over Iran's nuclear program was rising. In the year 2012 after a controversy result in the Iranian presidential election, the United Nations started imposing waves of sanctions against Iran because of human rights violations and also its nuclear deal program.

In the year 2015, an agreement, known as the Joint Comprehensive Plan of Action (JCPOA), was achieved between Iran and the P5+1 (the five permanent members of the United Nations Security Council—China, France, Russia, United Kingdom, United States—plus Germany). This resulted in the largest change in foreign investment in recent years with a 64% increase in 2016. This positive trend continued until 2017 and Iran experienced the highest amount of foreign direct investment with more than 5 billion dollars in 2017. Big corporations have entered Iran for foreign investment, including car manufacturing (such as Peugeot), airlines (such as Boeing and Airbus), oil and gas exploration and production companies such as Total. Following these big names, many companies from all over the world started to enter to Iranian market for investment. This improved the business environment and increased economic prosperity and growth (Aktij Shokrolah Tabar, 2019). With the Trump administration in power in 2017 and exiting JCPOA in 2018, sanctions on a large scale against Iran were reimposed. This resulted in a 30% drop in foreign direct investment in Iran in 2018 compared to the previous year. This negative decline has continued up to the present day.

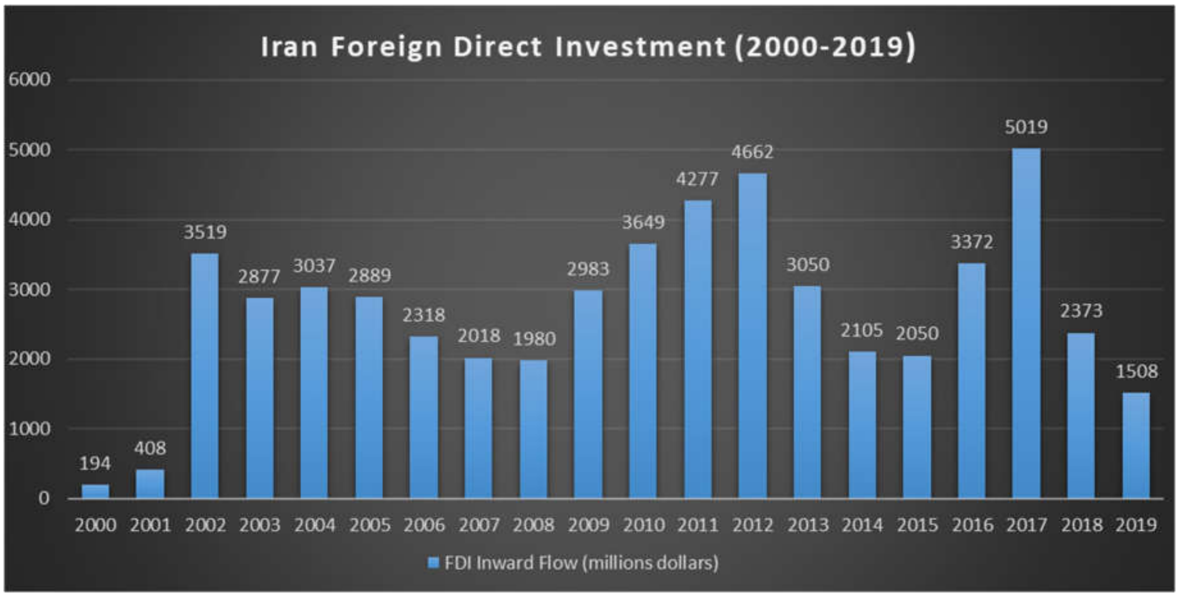

Figure 1. The foreign direct investment in Iran over the last two decades (millions of dollars) according to government official organizations
Source: UNCTAD https://unctadstat.unctad.org/

Previous Studies

The available literature on Foreign Direct Investment (FDI) flows into Iran is relatively limited, with most studies conducted by Iranian scholars and published primarily in domestic journals. While these publications often originate from prestigious Iranian universities, their reach within the international academic community is somewhat constrained.

A review of the existing research reveals two primary themes: the impact of FDI inflows on Iran's economy and the factors influencing these inflows. Within the first category, studies have explored the effects of FDI on various aspects of the Iranian economy, including economic growth, employment, technology transfer, and social development. For instance, [cite relevant studies here] have examined the correlation between FDI and GDP growth in Iran.

The second category of research focuses on identifying the determinants of FDI inflows into Iran. These studies have investigated a range of factors, such as economic stability, political risk, infrastructure development, government policies, and natural resource endowments. For example, [cite relevant studies here] have analyzed the role of government incentives and regulations in attracting FDI.

By reviewing these studies, it becomes evident that while significant progress has been made in understanding FDI dynamics in Iran, there is still a need for further research to address the complexities of this issue. Future studies could explore emerging trends, such as the impact of international sanctions and the role of digital technologies in FDI flows.

Effects of FDI on Iran’s Economy

Negahdari (2014) has studied the effect of foreign direct investment on economic growth among the Persian Gulf countries, including Iran between the years 1995-2011. The results show that foreign direct investment through the accumulation of physical capital has a positive and significant effect on the economic growth of these countries but in contrast, has a negative effect on human capital. In other words, due to the low level of human capital in the Persian Gulf countries, it is not possible to transfer technology through foreign direct investment, which prevents the increase of productivity and benefit of technology overflows, so that it is a deterrent to economic growth in these countries (Negahdari, 2014).

Yavari and Saadat (2005) have investigated the effect of foreign trade and foreign capital on economic growth in Iran. They have examined the economic growth resulting from foreign investment under business strategies between the years 1961 to 2001. Their results show that the economic growth due to foreign investment under the export development strategy is higher than the economic growth due to investment in the conditions of import substitution. In other words, in the import substitution policy, the government's strong support for domestic industries does not allow foreign investors to compete with domestic industries. Therefore, the share of foreign investment in economic growth decreases, while this share is high in terms of export development policy (Yavar & Rahman, 2005).

Karimi and Habibi (2017) investigate the effects of foreign direct investment on the economic growth of the Gulf Cooperation Council including Iran between 1980-2014. The result of their study implies that foreign direct investment is one of the most important factors for the economic growth of Iran and it has a steady-state relationship with the GDP of the country. In addition to that, the study states that the nuclear deal is known as JPCOA (Joint Comprehensive Plan of Action) between Iran and P5+1 countries is essential but not enough to attract foreign direct investment to Iran (Habibi & Karimi, 2017). Similarly, Ostadi et al. (2005) examined the role of foreign direct investment in Iran's economic growth and their relationship. Moreover, the study examined the theoretical aspects of how to attract foreign investment and explained the factors affecting the attraction of direct investment (including economic factors, incentives and support factors, natural factors, and political factors). The study discusses factors affecting economic growth and investigates the relationship between FDI and economic growth through econometric methods between 1978-2008. The results of the study show that economic growth, trade openness, and human capital have a positive effect on the process of attracting foreign direct investment. Moreover, the Granger causality test shows a correlation between economic growth and foreign direct investment (Ostadi et al., 2013).

Another study applies panel data and the least square approach to investigate the effect of FDI on the institutional gap in Iran and other selected countries in the time period between 2001 and 2017. The study implies that FDI and population variable has a significant and negative effect on the institutional gap in Iran. On the other hand, the study indicates that the economic growth variable has an insignificant and negative effect on the institutional gap in Iran, while this relationship was significant and positive for other countries (Bishak et al., 2011).

Regarding the effect of FDI on the employment rate, Rafat (2018) tries to explore the effect of foreign direct investment and international trade on the manufacturing employment rate in Iran. The result of the study illustrates a positive relationship between FDI and employment in manufacturing in Iran. Moreover, the study shows that the role of bilateral exports with Asian partners is weaker compared to European partners for Iran (Rafat, 2018).

Determinant of FDI for Iran

Davoodi and Shahmoradi (2004) examine the factors affecting the attraction of foreign direct investment in 47 countries including Iran during the period 1990-2002. The analysis is performed within the fixed effect framework to distinguish specific differences in each country. The results of the study show that attention to legal infrastructure, encouraging and strengthening domestic investment in the private sector, attention to efficiency and productivity of investments made in infrastructure and R&D facilities, attention to efficiency, productivity, and skill level of the workforce and, measures to increase the country's political stability may lead to attracting foreign direct investment in Iran. (Davoodi & Shahmoradi, 2004)

Zomordian et al. (2018) try to answer the question of why Iran has not been successful in attracting foreign investment to the country and identify factors affecting FDI. This study, in the form of an econometric model using a recursive method with distributed interruption, examines the impact of the development of financial markets (monetary and capital) on foreign direct investment during the period 1971 to 2014 in the Iranian economy. The results indicate that, first, there is a long-run equilibrium relationship between the growth of financial markets and foreign direct investment. Secondly, in the short run, the development of financial markets has a positive effect on foreign direct investment. This impact is confirmed in the long run for the money markets, but not in the case of the capital market. In addition, it was found that the positive effect of capital stock, tariff rate, and nominal wage index has a negative impact on foreign investment. (Zomordian et al., 2018).

In another study, the effect of the exchange rate, infrastructures and, openness on FDI in Iran during 1975-2007 was investigated. It was found that these factors were significant in explaining FDI in the long term for Iran. The results also confirmed the negative effect of the revolution and the eight-year war on Iran’s foreign direct investment during the 1980s (Mohammadvandnahidi et al., 2012).

Regarding the country risk, Rafat and Farahani (2019) try to investigate the relationships between the political risks and foreign direct investment inflow in Iran based on International Country Risk Guide (ICRG) indices. The study implemented a two-stage least square estimator for a thirty years span of data. The result of the study states that military presence in politics and democratic accountability are the two most important factors among all statistically significant indicators. Other factors such as socioeconomic conditions (unemployment rate, poverty rate and, consumer confidence), ethnic and religious tensions, low and order, investment profile and, external and internal conflicts are some important determinants of FDI flow in Iran. It is important to mention that external conflicts, in this case, are related to the risk for the incumbent government from foreign action that can range from trade sanctions and diplomatic pressures to violent actions such as war (Rafat & Farahani, 2019).

DISCUSSION AND SUGGESTION

The positive effects of FDI on many aspects of Iran's economy are well documented by scholars in the literature. Moreover, major external and internal factors that affect the FDI inflow into the country are discussed as well. However, very few studies have been conducted on ways/approaches to address at least internal obstacles and challenges. Perhaps studying other countries that suffered from some of these obstacles and comparing them with Iran's current situation can contribute to this field.

A quick glance at the topic of published studies reveals that the main focus has been on inward FDI only. Very few, if anyone, studies have been done on Iranian multinational enterprises (MNE) and the outward FDI flow of Iran. Of course, this can be due to the little amount of outflows FDI of Iran. According to the 2020 report of UNCTAD, Iran outward FDI was estimated to be 85 million dollars in the year 2019 (UNTCAD,2020). For the sake of comparison, this amount was 2,841 million dollars for Turkey in the same year. Other reasons for having such low FDI outflow could be U.S sanctions on the country and the fear of uncertainty for the security of investments. On the other hand, Iranian knowledge-based firms are emerging. Many of these companies are start-up companies that do not need a huge investment to operate abroad. Studying Iranian MNEs in the context of entrepreneurship approaches seem like a promising research area in the future.

This study highlights several critical insights that are relevant not only to Iran but also to the broader Middle Eastern region. Historically, Iran has been a focal point for FDI due to its rich natural resources, strategic location, and large domestic market. However, various political and economic factors have influenced investment flows, leading to fluctuations in FDI levels over the decades. This inconsistency underscores the importance of political stability and a transparent regulatory framework in attracting foreign investors. The U.S. withdrawal from the JCPOA and the subsequent reinstatement of stringent economic sanctions against Iran created a challenging environment for foreign investors. Many international companies, particularly those from Europe and Asia, had been eager to invest in Iran following the lifting of sanctions under the JCPOA . However, Trump's re-imposition of sanctions effectively deterred foreign companies from doing business with Iran (Nuruzzaman, 2020). If Donald Trump were to win the 2024 election, his foreign policy approach would likely echo many of his strategies from his first term. A key element of his administration's approach was the "maximum pressure" campaign against Iran, which involved the reinstatement of stringent sanctions following the U.S. withdrawal from the JCPOA. This shift severely crippled Iran's ability to attract foreign investments, especially from Western companies, due to the risk of secondary sanctions and the complex legal and financial landscape created by U.S. policies. In the event of a second Trump presidency, it is likely that he would reinstate or even strengthen these sanctions, further deterring international companies from investing in Iran. The re-imposition of sanctions could exacerbate Iran's economic isolation and hinder foreign interest in its energy, infrastructure, and manufacturing sectors, where opportunities for growth exist. Given that Trump's policies have historically been aimed at isolating Iran economically and diplomatically, FDI in Iran would face significant challenges under a Trump-led administration.

The determinants of FDI in Iran, such as market size, infrastructure quality, and workforce skills, resonate with trends observed in other Middle Eastern countries. For instance, as nations in the region seek to diversify their economies away from oil dependency, the lessons learned from Iran's FDI experiences can be instrumental. Furthermore, the effects of FDI in Iran provide a broader context for understanding economic development in the Middle East. FDI has the potential to drive technological advancement, create jobs, and enhance local industries. However, the benefits of FDI can only be fully realized if there is a commitment to developing local capacities and infrastructure.

This calls for a collaborative approach among Middle Eastern nations to share best practices and foster an environment conducive to sustainable investment.

The discussion of FDI in Iran serves as a microcosm for the broader regional dynamics in the Middle East. By addressing the challenges and leveraging the opportunities presented by FDI, countries in the region can collectively enhance their economic resilience and promote sustainable development. Continued research in this area will be essential for informing policy decisions and fostering a more integrated and prosperous Middle Eastern economy.

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