Breaking the Vicious Cycle of Uncertainty in Post-Communist Russia

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In the wake of communism's collapse in 1991, many Western observers expected post-Soviet Russia to undergo a relatively smooth transition to democracy and a market economy. Instead, for the past seven years, the Russian Federation has lurched from one severe crisis to another: extremely high inflation in 1992; a near civil war between forces supporting the president and the Congress of People's Deputies in 1993; a costly, bloody, and inept military invasion of Chechnya beginning in 1994, disturbingly strong electoral performances by anti-liberal ideologues in parliamentary and presidential elections in 1993, 1995 and 1996; and now a devastating financial crisis that threatens to undermine the political and economic framework of the current regime altogether. What explains this dismal record? What can the West now do about it?

A key but underemphasized factor underlying the political and economic turmoil in post-communist Russia is the high degree of uncertainty about the future that has confronted Russian elites and ordinary people alike since the breakup of the USSR. In the face of such high uncertainty, long-term investments of every sort, both economic and political, have become irrational. Unfortunately, a society in which all decision-making is overwhelmingly short term in nature is bound to generate repeated institutional crises--which make the future even more uncertain. Understanding the dynamics of this vicious cycle of uncertainty is crucial, I argue, if Russia and the West hope to devise effective policies for breaking out of it.

Economic Effects of Uncertainty

The original strategy for rapid marketization of the post-Soviet economy in Russia was based upon the theory that macroeconomic stabilization, price and tariff liberalization, and privatization of state property would, after a painful but relatively quick period of adjustment, generate increased efficiency and economic growth. By 1997, substantial progress had been achieved in these main policy arenas: inflation was down to single digits for the year, price controls had largely been abandoned, and around two-thirds of state property had been formally transferred to the private sector.

As the decade comes to a close, however, Russia still suffers both from a continuing dramatic decline in GDP and a renewed threat of hyperinflation. Why? Analysts have identified several economic reasons for these bad outcomes: comparatively low levels of foreign and domestic direct investment, a very limited degree of enterprise and farm restructuring, capital flight amounting to tens of billions of dollars per year, severe problems with tax collection, and, as a

result of all the above factors, an increasing dependence on unsustainable short-term debt to finance basic government operations.

Each of these problems flows directly from the choices of rational actors in a society facing extraordinarily high levels of uncertainty. The paucity of large-scale direct investment in the Russian economy by foreign and domestic actors alike is quite easily explained: given the political and social turbulence of the past decade, only a fool would sink substantial resources into projects that might require years to yield positive returns. Russia's inheritance of a crumbling and technologically outdated infrastructure exacerbated this dilemma, since, as a result, even light industry and consumer goods production often require significant initial capital outlays that no rational actor will make. It is understandable that Russian entrepreneurs have concentrated on sectors with low start-up costs, like "shuttle trading" (buying goods abroad and selling them on the streets) and the export of raw materials through old Soviet distribution networks.

Nor should economists have been surprised to discover that the new "owners" of rapidly privatized state factories and collective farms didn't often sink scarce resources into full-scale restructuring. To do so would be rational only if one expected the rules of competitive capitalism to be the "only game in town" several years from now--but such confidence about the future of market institutions in Russia is itself hardly rational. A prudent factory manager is forced to hedge his bets, leasing some parts of his enterprise to market-oriented entrepreneurs and stripping other factory assets to sell for cash, but also cultivating personal ties to local and national politicians, pleading for continued state subsidies, and leaving large numbers of workers on the payroll (even if there are no funds to pay them with) so as not to diminish the factory's political clout in case of an anti-market political backlash. It is rational, too, to put at least a certain percentage of the enterprise's liquid assets into dollars or personal offshore accounts: given high social uncertainty, the costs of possible future prosecution for this sort of corruption must be discounted heavily and weighed against the benefits of having a "nest egg" in case of economic meltdown. The same sort of reasoning applies to decisions to pay or evade taxes: to the extent that a state which may not exist much longer must rely on personal reporting of income, rational actors will quite understandably conceal whatever they can.

Certainly Western economists were right to warn against the inflationary effects of printing money for government spending in the economic environment described above: when revolutionary change is a real possibility, the value of large quantities of government-issued paper is likely to decline especially rapidly. IMF advice to raise tax revenues substantially, however, was also unrealistic under the circumstances. Finally, given high social uncertainty, basing government finance on short-term bonds couldn't work either: rational actors invest only when offered absurdly high interest rates, but the resulting debt burden made subsequent government pledges to preserve low inflation and a stable ruble exchange rate even less credible. Arguably, then, it was the inability of the Russian Federation to escape the vicious cycle of uncertainty, and not so much bad economic policy decisions per se, that underlay the financial collapse of 1998.

Political Effects of Uncertainty

As more and more economists have begun to see how the warped incentives of an uncertain society can undermine economic reform, increased emphasis has been placed on the need for "good governance" during market transitions. Governments, we are told, must observe and implement the "rule of law" in order to reduce uncertainty about the sanctity of contracts and the inviolability of property rights. A well-functioning judiciary is the crucial foundation for this. Supporters of reform also call for the formation of a stable electoral system based on political parties that truly represent their constituents. Above all, bureaucratic corruption must somehow be brought under control so that economic policy is made consistent and credible.

Unfortunately, such well-meaning advice also ignores the vicious cycle of uncertainty. In extremely turbulent societies, rational actors are no more likely to invest in long-term political institution-building than in long-term economic projects. While everyone would undoubtedly be better off in a society with stable legal procedures, truly representative democratic institutions, and uncorrupted public officials, no single individual can contribute anything significant to ensuring such an outcome. Indeed, in a society where everyone assumes that the government may collapse within a few years or months, individuals who respect the rule of law inevitably lose out: they get neither the benefits of a law-governed society nor the payoffs from corruption. Under highly uncertain conditions, then, rational citizens should ignore laws when they can and organize only when directly threatened; rational judges should worry more about pleasing powerful patrons than upholding abstract legal principles; and rational politicians should fight for control over state assets rather than pay the high cost of developing genuine national organizations to represent ordinary people. Attempts to create special government bodies to control corruption in such an environment just recreate the problem on a higher level, since every watchdog agency is, by definition, in an even better position to extract bribes. In short, under conditions of high uncertainty, general and perpetual corruption is precisely what standard economic theory would predict.

Environments of high uncertainty have another perverse political effect: they tend to promote radical ideologues while punishing moderates. In an environment of repeated political crisis, ordinary, pragmatic politicians are forced to change their public positions every few months. Over time, then, avowed "centrists" lose all credibility. The only consistent people in chaotic societies are radicals with inflexible views of the long-run future. The persistent uncertainty in Russia since 1990 has made extremists like Vladimir Zhirinovskii and Gennadii Ziuganov--both of whom had by 1993 already published quite explicit and detailed manifestos calling for the resurrection of empire and warning of a supposed global conspiracy to destroy Russia--seem relatively principled and credible to their supporters. To be sure, the majority of Russian voters continue to reject extremism. But as long as significant minorities vote for anti-liberal ideologues, the stability of Russian electoral democracy will remain in doubt, further deepening uncertainty about the political future. Given Russia's significant arsenal of biological, chemical, and nuclear weapons, this is a dynamic that should be of direct concern to the West.

Breaking the Cycle

Fortunately, there are potential methods for breaking the vicious cycle of uncertainty that do not require the victory of extremist ideologues. One possible solution is to design and publicize a more realistic long-term strategy for Russian integration into the peaceful and wealthy West, instead of demanding impossible short-term transformations. For those post-communist countries closest to Western Europe, widespread calculations about the feasibility of eventual membership in NATO and/or the European Union have done much to extend time horizons and make cooperative political and economic behavior individually rational. Indeed, in East-Central Europe, early individual decisions to build national democratic institutions and to sink resources into long-term investment have generally paid off. A widespread desire to be accepted as a part of "Europe," it appears, has thus helped to moderate both short-term corruption and long-term extremism in almost every post-communist European country.

Another method for reducing social uncertainty involves the generation and promotion of grass-roots networks of mutual trust and support. Even in the most chaotic environments, ties of family, of friendship, and of mutual experience keep social life from degenerating entirely into a "war of all against all." People in established communities everywhere tend to develop an acute sense for who can be trusted to engage in long-term cooperation and who cannot. Where state institutions and formal economic laws cease to function, informal ties of this sort become all the more important--as indeed they are in Russia today. In time, such communities can become the basis for the recruitment of committed activists interested in pooling their resources on a national level to create effective political parties and organized interest groups. As we enter the 21st century, we can expect that such grass-roots mobilization in Russia will further rather than hinder the progress of liberal institutions. Russians have already suffered through one anti-liberal ideological experiment, and given any sort of workable alternative, most would be very unlikely to support another one. The goals of civil society activists in Russia today--better protection for small business, more consistent law enforcement, more responsive local and federal government, and so on--are generally highly compatible with Western ideals.

However, US policy since 1991 has tended to short-circuit both Russian faith in its long-term prospects for integration with the West and the process of grass-roots political and economic organization, while inadvertently encouraging the sorts of crises that deepen the vicious cycle of uncertainty. IMF-sponsored economic reforms have been predicated upon the mistaken idea that rapid transformations of Soviet institutions were crucial to make reform "irreversible." Thus elites and masses alike have been subjected to unsettling revolutionary changes in their daily life that were bound to upset social confidence in the future. These initial shocks have been followed in recent years by official Western recommendations to the Yeltsin government to raise utility prices for domestic consumers to world market levels within a few years, to fire huge numbers of workers in important sectors of government and industry, and to impose stricter bankruptcy laws on failing enterprises. All of these policies, once proposed--even if never implemented--have tended to force average Russians to think about their economic survival in the near term rather than their best strategies for attaining wealth in the long run. At the same time, the West has introduced a new source of uncertainty in the international arena by proposing a policy of rapid NATO expansion that implicitly envisions the potential incorporation of every country in Europe but Russia. To be sure, the problem of uncertainty in post-communist Russia would have been

enormous in any case, and the inconsistencies of the Yeltsin administration itself obviously haven't helped matters. Still, Western policy toward Russia has demonstrated a remarkable insensitivity to the pernicious dynamics of social uncertainty outlined above.

One final implication of the analysis presented here is that "cultural" explanations for what has gone wrong in Russia are at best partial and at worst pernicious. It is far too easy for Western analysts to blame the poor results of reforms in Russia on a supposed "authoritarian and collectivist" mentality that has prevented citizens and entrepreneurs from behaving as predicted by Western democratic and economic theory. Actually, as we have seen, standard rational actor theory explains outcomes in Russia perfectly. If so, it is outrageous to announce now that Russians have somehow "failed to understand the market economy" and must be left to figure it out for themselves. It is we who have failed to think through the logical implications of the theoretical assumptions about human behavior upon which the Russian reform strategy was originally predicated.