What Does Modern Political Economics Tell Us about the Fate of Russia's Reforms?

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September, 2011

After the 2008-09 crisis, Russia is facing a new set of challenges. The pre-crisis sources of growth have been exhausted. In order to implement its growth potential and catch up with OECD countries, Russia must improve its investment and business climate. Although the reform agenda has been repeatedly discussed, it is not being implemented. The explanation is provided by modern political economics: what is good policy (in terms of social welfare and growth) is not necessarily good politics (for a country's rulers). In this sense, modern Russia is a perfect example of the non-existence of a political Coase theorem. Although everybody understands that the status quo is suboptimal, the most likely outcome is further postponement of reforms.

Whither Russia?

In 2009, the New Economic School joined the Russia Balance Sheet project launched by two DC-based think tanks: the Center for Strategic and International Studies and the Peterson Institute for International Economics. The aim of the project was to assess Russia's assets and liabilities. Similarly to compiling a company's balance sheet, the project estimated the potential for long-term development and growth, and the problems that could prevent Russia from realizing this potential.

The main output of the project in 2009-10 was the book "*Russia after the Global Economic Crisis*", which was published in English in the Spring 2010 and in Russian in the fall of the same year. The book looked at a broad range of issues that could be classified as Russia's "assets" and "liabilities", extending from economic, political and social issues to energy, foreign relations, climate change, innovation and military reform. Interestingly, despite the breadth of the analysis, the authors of the book's different chapters arrived at similar conclusions, which might be summarized as follows: while Russia came out of the crisis in a reasonably good shape and has nothing to fear in the near term, it has serious long-term problems that need to be addressed as soon as possible; however , it is unfortunately the case that Russia is unlikely to implement the required reforms, since they go against the interests of the ruling elite.

This argument is especially clear with respect to Russia's economic problems – that Aleh Tsyvinski and I analyzed in the first chapter of the book. In the short run the Russian economy is certainly doing quite well. So long as oil prices stay high, the budget remains balanced, the economy grows, and sovereign debt is virtually non-existent (in marked contrast with debt burdens of OECD countries). Contrary to what is claimed by many critics of the government, pre-crisis growth did trickle down to all parts of Russian society, and that has ensured that the government enjoys sufficient political support.

However, in the long run, the situation is very different. The pre-crisis sources of economic growth (rising oil prices, low capacity utilization and an underemployed labor force) have all been exhausted. Oil prices are high, but are unlikely to rise much further. Production capacity and infrastructure are over-utilized. The labor market is very tight. In order to grow at the rates, which Korea and other fast-growing countries achieved when they were at Russia's level of development, Russia needs new investment. Hence, Russia has to improve the business climate and the investment climate. This, in turn, depends on reducing corruption, improving protection of property rights, building an effective and independent judiciary, and opening the economy to competition (both domestic and international).

Good Policy, Bad Policy

The changes that are needed in order to ensure strong growth are obvious, but they are unlikely to happen. The reason is very simple: the political equilibrium is such that Russia's political elite is not interested in change. There is nothing unusual about this. As Bueno de Mesquita et al. (2003) have argued: good policy may be bad politics and vice versa. If achievement of economic growth depends on surrendering control over the commanding heights of the economy (through privatization, strengthening the rule of law, deregulation, and encouragement of competition), the ruling elite may fear a weakening of its hold on power and ultimate loss of power as the price of achieving growth. In this case, the ruling elite will prefer to stay in charge of a stagnating economy (and enjoy a big piece of a small cake) rather than risk losing power (and having no piece of a bigger cake).

Can society somehow buy out the vested interests of the rulers? One of the most powerful theoretical results in economics, the Coase theorem, would suggest that the answer is yes. However, the conditions of the Coase theorem are not met in the instance of political economy, which we are considering. In our case the ruling elite does not merely trade goods or even assets: by allowing reforms it would lose the power to expropriate and protection from being expropriated. Unsurprisingly, there is no "political Coase theorem" (see Acemoglu, 2003).

As we discuss in Guriev et al. (2009), this problem is particularly acute in resource-rich transition economies without established political and legal institutions. In such economies, the lack of institutions means that the rulers are less accountable and can therefore appropriate a large share of the resource rents. The resource rents increase the incentives to hold on to power and provide the rulers with the resources which they need in order to maintain the status quo.

In the opening chapter of "Russia After the Global Economic Crisis", Aleh Tsyvinski and myself argued that this is precisely Russia's problem. We punningly defined the status quo as a "70-80 scenario": if the oil price stayed fairly high ($70-80 per barrel) then Russia would be likely to follow the 1970-80s experience of the Soviet Union, when reforms were shelved and the economy stagnated. That period ended with the bankruptcy and disintegration of the Soviet Union.

Certainly, the differences between modern Russia and the 1970-80s Soviet Union are substantial. Although the government controls the commanding heights of the modern Russian economy, the nature of the latter is capitalist and not command. Also, Russian economic policymakers are much more competent and, unlike their Soviet predecessors, they can easily believe that if a country runs out of cash, the government is removed from office: they have seen it happen to those same Soviet predecessors.

This brings us to a conundrum: if it is clear that the status quo is a dead-end, what is the ruling elite hoping for? On the one hand, the elite understands all too well that reforms are risky – everybody remembers the last Soviet government, which initiated change and lost power as a result of that change. On the other hand, it is clear that in order to remain in power the government needs growth and that growth can only come from reforms.

Rational Overconfidence

The solution to this conundrum is to be found, not in modern political economics, but in the realm of behavioral economics and studies of leadership. In recent years, economists have been keen to integrate insights from psychology into their models of markets and organizations.

Psychologists know very well that human beings want to be happy, and are therefore disposed to forget bad news and remember only good news. They also like to persuade themselves that they are good (or at least better than others). This explains why investors always want to believe in more optimistic scenarios (hence bubbles, see Akerlof and Shiller, 2009). Furthermore, a certain degree of over-optimism on the part of leaders is actually “rational” or “optimal” (see Van den Steen, 2005, and Guriev and Suvorov, 2010). Over-optimistic leaders are more resolute, and they attract more capable and enthusiastic followers. In this sense, in an environment with weak political institutions, over-optimistic political leaders always crowd out more realistic leaders (who do not promise as much). Where there are strong political institutions that ensure political accountability (e.g. via political parties), this behavior is not sustainable. But if there is no accountability, over-optimism almost inevitably prevails as a result of political selection.

This may explain why the Russian political leadership hopes for the better. So far the model “whenever we are in trouble, the oil price goes up and saves us” has worked, and it will keep working until the oil price goes down and undermines both macroeconomic and political stability. Once again, resource abundance is important as it helps to feed the over-optimism: the fortunate leaders that rule during the period of high oil prices can easily believe that their luck is permanent and their belief (or, as the leadership literature calls it, “vision”) will be consistent with the evidence – but only until the oil price plunge.

The 70-80 Scenario: Two Years On

We started to write the 70-80 chapter in the fall of 2009, when the oil price was already back from $40 per barrel to the fiscally comfortable range of $70-80 dollars. What has happened since then to the likelihood and sustainability of our scenario?

What we find is that, although the 70-80 pun no longer works, our main argument has been reinforced. First, the oil price is no longer in the range of $70-80 per barrel, but has risen higher due to events in the Middle East and Japan, as well as increased demand for oil as a store of value reflecting diminished confidence in dollar and euro assets. Second, the Arab Spring has made the Russian government suspect that its hold on power is more tenuous than it previously believed, and it has started to spend even more aggressively. Russia’s budget is no longer in surplus at $70 per barrel: it can now only be balanced if the oil price is at $125 per barrel (!). In this sense, $70-80 per barrel is no longer a “high” price – it is both below the current market’s expectations and below the Russian government’s fiscal benchmarks.

However, our main argument has been reconfirmed. High oil prices have encouraged the Russian government to become further entrenched in the status quo scenario. While there has been a substantial increase in rhetoric about privatization, deregulation, competition, rule of law etc., actual change has been lacking. On the contrary, there is increasing reliance on government ownership and increasing probability that Russia will move further down the road to stagnation after the presidential elections of 2012.

Can There Be An Alternative to Stagnation?

In "*Russia after the Global Economic Crisis*" we also charted an alternative scenario based on reforms that help to realize Russia's substantial growth potential. Is this scenario feasible? Certainly, the laws of political economy are not deterministic. Even though the status quo path is preferable for the country's rulers, a leader (or a sub-group in the elite) may emerge who is long-term-oriented and is not over-optimistic. If this leader or group manages to create a critical mass of stakeholders for reforms, there may be a "run" on the status quo. For example, if the oil price decreases and there is fiscal pressure to privatize, then a critical mass of private owners may emerge who are interested in protection of property rights and the rule-of-law.

However, even though a positive scenario is possible, it is not very likely. Investors have already reached this conclusion: Russia has been experiencing large capital flight since the fall of 2010 (net capital outflow is about of 5% of GDP). Investors are not yet ready to bet their money on the good scenario. Nor would political economists recommend them to do so.

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