

Economic Assistance to Russia: Ineffectual, Politicized, and Corrupt?

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While it is easy to critique reform programs after the fact--and therefore also easy to dismiss critics--understanding why economic assistance to Russia seems to have failed remains a vitally important task for the United States. We must learn the lessons of the Russian experience with economic reform not only in order to be able to more successfully assist Russia in the future, but also, and perhaps more importantly, in order to advance our understanding of the principals of economic assistance and reform in the more general context of democratizing countries around the world.

Foreign economic assistance to Russia has been criticized on a number of fronts:

- Many argue that economic assistance to Russia has been ineffective; after nearly 10 years of economic reform, key economic goals have not been achieved;
- It is argued that economic aid to Russia was overly politicized; that is, economic assistance has served political rather than economic objectives; and
- Perhaps most seriously, some have argued that foreign economic assistance to Russia has actually worsened the Russian economy by fostering corruption.

Effectiveness

It is hard to dispute the finding that Russia's economy is in shambles. In comparison to other countries of Eastern Europe, or even to its own pre-reform communist past, current Russian economic conditions are dismal. Given the fact that during the 1990s Russia nearly set several world records in poor economic performance, we need not delve into the complexities of measuring the effectiveness of economic assistance, because we can safely say that assistance so far has not been as effective as was initially hoped. Despite differences of opinion over what could or should have been done, nearly all would agree that there is room for improving the effectiveness of economic assistance. It is important to recognize that an assessment that shows economic assistance has not been very effective so far does not in itself justify giving up on foreign assistance to Russia (and to other countries). Instead it is a call first to figure out why assistance has not been as effective as was hoped, and second to improve the way assistance is carried out. In other words, ineffectiveness is a signal that we need to work harder on figuring out what works in terms of economic assistance.

The Relationship Between Politics and Economics

A common criticism of economic assistance to Russia, and a common argument for why it has been ineffective, is that economic assistance was overly politicized. There is no question that IMF lending to Russia, for example, was politicized. This has spurred some critics to argue that the goals and activities of the IMF should be severely curtailed. However, the idea that economic reform is an entirely economic process devoid of politics is simply wrong. Therefore, an attempt to ignore politics in the process of economic assistance would likely prove unsuccessful. For that reason, some argue that international institutions and even foreign governments should not get involved in economic reform, but should restrict their activities to crisis management or other "purely" economic activities.

Yet the imperative to scale back international institutions and focus on economics instead of politics misses an important point: we cannot ignore politics--instead we need to get the political and economic relationships right. Recognizing that economic reform is partly a political process does not mean that we should forget about economic goals. Similarly, it does not mean that economic goals should be measured in political terms, or that political goals should be measured in economic terms. For example, we should not measure democracy in terms of annual economic growth rather than free and fair elections, and likewise we should not measure the success of privatization in terms of "depoliticization" rather than in terms of efficiency.

Numerous studies have shown that economic and political reforms seem to move together. But beyond this correlation, the nature of the relationship between the two remains unclear. We know that economic growth alone does not in itself cause democracy. And we know that a government's democratic political orientation also does not cause economic growth. While social scientists work towards understanding the causes of democratic and economic performance, policymakers should treat the correlation between political and economic reform carefully.

In short, I suggest that we fully integrate political and economic variables into our analyses of economic reform, but in setting policy goals we must be clear on the outcomes we are working towards and not get lulled into assuming that political and economic results can be substituted for one another. In practical terms that means that a stabilization policy should be based on its ability to improve the fiscal position of the state, not on its ability to improve the current political position of the government. Experience in Russia demonstrates that it was misguided to hope that the right politics could substitute for real economic achievements. By staying focused on the goals we wish to achieve we can avoid both the impossible task of ignoring politics in economic reform and the negative experience of having ignored fundamental economic indicators.

Corruption

A third major criticism of foreign economic assistance to Russia is that aid was associated with corruption. Claims of corruption can be distinguished into two (not mutually exclusive) types. First, some argue that those involved in economic assistance were themselves corrupt and were seeking to profit personally (and illegally) from the process of economic reform. A second claim is that the economic reform process itself, which was heavily influenced by foreign advice, fostered the growth of widespread corruption in Russia. The first type of claim focuses attention on the people involved in implementing reform, and the second concerns the broader consequences of the reform process.

While there is evidence that certain individuals involved in the reform process engaged in questionable activity, there is no evidence of a conspiracy by foreign economic advisors, international institutions, and Russian officials. That is, this type of corruption appears to be individual rather than systemic in nature. Obviously, such aberrations should be fully investigated and appropriate safeguards should be put in place to reduce the possibility of future abuses. Nevertheless, addressing this first type of corruption still leaves us with the second type of claim, namely that the process of economic reform--and the role of foreign assistance in that process--produced or at a minimum greatly contributed to the growth of corruption in Russia.

A careful examination of economic reform in Russia yields the conclusion that corruption is fundamentally a result of the privileging of specific groups of people over institutions during the course of reform. In particular, there were three steps in the process of economic reform that led to corruption, and unfortunately each of these steps was strongly supported by foreign economic advisors.

- division of society into groups or types of people (e.g., "reformers" vs. "communists");
- the reliance on making deals with individuals or groups of the chosen type in order to implement reform, rather than relying on institutionalized universal rules; and
- neglect of institutional development (which was partly a consequence of the previous step).

In Russia, universal economic rationality--the idea that all people respond to a set of choices according to their preferences, information, and the incentives associated with certain choices--was asserted in order to justify the appropriateness of a neoliberal reform program. However, there was an unfortunate reversion to culturally and historically given "types" in the implementation of reforms, and this reliance on types, as we will see, undermined institutional development.

A review of available evidence shows that during the process of Russian economic reform, policymakers divided Russian society into two principal types: "reformers" and

"enemies of reform." The "reformers" were under 40 years old, free from communist ideology, and could be expected to act rationally. Among the reformers there were only a handful of economists and politicians, because it was asserted that most politicians and economists were driven by communist ideas and experience. The rest of the reformers were the so-called "stakeholders," or new private owners, a group mostly comprised of former industrial managers. A prominent foreign economic advisor explained that the reformers represent the "productive part of the economy" and their "political enemies represent the unproductive part." The enemies of reform were characterized as the over-40 industrial nomenklatura, who had a "Soviet mentality" and were production-rather than stabilization-oriented.

An immediately obvious problem with this typology is that the nomenklatura--the political and economic elite from the Soviet period--show up both as reformers and as enemies of reform, for the "new private owners" were nothing more than the old enterprise directors. Moreover, an examination of reformers' own analyses show that the composition of the groups shifts over time.

Unfortunately, the problem of dividing society into groups and types of people was not merely a theoretical problem. Instead, the division of society into types of people who either could or could not rationally respond to reform initiatives and their resulting incentives constituted the basis for moving the reform program away from universal standards towards particularistic deals and bargains with certain groups.

Particularistic Bargaining

The logic of particularistic deals was based on four assumptions, and I will illustrate these assumptions with examples from the privatization process. The first assumption was that reformers were rational, and that the enemies of reform were irrational; irrational means that choices were driven by ideology or beliefs rather than by preferences, information, and incentives. Second, it was assumed that given their irrational nature, enemies of reform would not respond to universal incentives in the form of institutions. In the case of privatization, certain enterprise directors were considered rational in that if they were given private property they were expected to respond appropriately to the demands of the market (e.g., improve profitability and efficiency). On the other hand, "old guard" or "communist" directors were expected to continue their business practices according to communist ideology no matter what was given to them--even if given ownership, they would not restructure their enterprises, but would continue with inefficient practices such as producing goods for which there was little demand or retaining unproductive workers. Because these communists were irrational and did not respond to universal institutions such as private property, they were to be disenfranchised from the economic system by having their property distributed among reform-oriented managers.

Institutions are governance structures or sets of rules that shape outcomes by changing the incentives for a particular choice. Institutions work to the extent that they support

stable equilibria even given a variety of interests. They are structural features of an economic system that induce certain outcomes by lowering the costs of particular choices (or raising the costs of alternatives). For most economists, institutions do not require homogeneous interests, moral commitments, or historically motivated consensus. Institutions are crucial to the notion of universal economic rationality, because institutions and the incentives they provide mediate choices. As is clear from the example above, this understanding of institutions is in tension with the idea that only certain types of people, namely reformers rather than communists, can respond to institutional incentive structures.

Third, it was argued that because the enemies of reform constituted a serious and imminent threat, extraordinary action was necessary. For privatization this meant handing over assets as quickly as possible to the right types of people, far in advance of institutional development. For example, vouchers were distributed before there were any investment funds (or even laws for regulating such funds), and before most firms had been privatized so that there was virtually nothing in which to invest the vouchers. The rationale was that voucher privatization needed to be done quickly above all else, so as to limit communist opposition.

Finally it was assumed that the enemies of reform would not respond to institutions, but that they could be individually "bought off" or co-opted through particularistic deals and the creation of "rents" or side-payments. The most obvious example of this was the infamous set of "loans-for-shares" deals in which firms and assets were sold for a song, profiting certain individuals at the expense of the rule of law and society at large. These deals were justified on the basis of buying the support of the oligarchs in order to defeat the communists in the 1996 election. This assumption that rents rather than institutions were the way to handle the interests of those opposed to reform constituted a crucial mistake in the economic reform process.

The expansion of particularistic bargaining and extra-legal deal-making with specially chosen individuals and groups seriously undermined reforms and supported the development of corruption because it was a strategy aimed at skirting traditional economic institutions and delegitimizing the rule of law. Rather than trying to gain the support of those opposed to economic reform by demonstrating the equal opportunities afforded by new universal economic institutions, the existence of anti-reform groups in society was seized upon by reformers in order to justify special deals and insider bargains. And, insider deals with stakeholders and other groups were constantly justified as being the only way to get economic reform implemented. Of course, under such circumstances the meaning of "reform" seems rather empty.

Enervating Institutions

A common response to the criticism that institutional development was neglected during the course of economic reforms is that institutions take a long time to develop and hence that institutional development was not feasible in the short term. A related argument is

that because institutions were weak, people rather than institutions had to be relied upon. These arguments were trumpeted by a host of foreign economic advisors and economic assistance proceeded in terms of choosing the right people to work with, rather than the right institutions. However, we should recognize that in certain spheres, such as standardizing of accounting principles, institutional development was pursued. The argument is not that nothing was done in terms of institutional development, but rather that much more could have and should have been done.

It is obvious that institutional development is a very complex process. Institutions take time and effort to develop--they do not develop spontaneously. Although we have yet to fully understand how institutions are formed and what makes them durable, we do know that establishment of rents and particularistic deals seriously undermines the prospects for institutional development. As long as individuals are rewarded for bypassing institutions and the rule of law, there is little hope for the consolidation of nascent institutions. If there was any doubt, the Russian experience with economic reform confirms that choosing people over institutions undermines the rule of law and leads to corruption.

Conclusion

The primary lessons to be drawn from the experience of economic assistance to Russia are the following:

- Do not give up on assistance just because it has not been very effective thus far; instead, find ways to improve assistance;
- Get the political and economic relationship right. Recognize that politics affects economic reform, but measure economic goals by economic criteria; and
- Support the development of institutions rather than specific personnel; despite pragmatic justifications, insider deals and the promotion of people over institutions simply leads to corruption.