Russia as a Failed Developmental State: Economic Policy and Predation under Sanctions

David Szakonyi

Stanford | Freeman Spogli Institute for International Studies

September 2020

Introduction

The evolution of Russia's economic model over the past decade has had its share of both policy successes and failures. On the one hand, Russian officials, drawing inspiration from East Asian developmental states in their model of economic growth, have produced a number of successes in the past decade. Ambitious interventions have thrust the government into the center of much economic activity. Protectionist and import substitution policies shield many key sectors from international competition. Numerous experiments are underway to modernize the bureaucracy.

On the other hand, although the government has selectively implemented various aspects of the developmental state model, growth remains lackluster and the quality of life for many in Russia is declining. In all, by prioritizing elite consolidation and consensus, the government's actions have generated massive upwards redistribution and growing levels of politically volatile inequality.

U.S. policymakers should not only recognize the significant diversity in performance and competence among Russian government agencies, but also more actively engage officials and private sector actors keen to reform the country's economic and bureaucratic institutions.

Developmental States and Economic Growth

Russian economists and politicians have looked to the developmental state model of economic governance when considering ways to achieve long-term economic goals. Before describing Russian economic policy, it is worth looking at how some of those tactics have succeeded in East and Southeast Asia.

The developmental state model served many countries well in the 20th century. For instance, following World War II, Japan was quickly able to rebound and modernize. Later adopting many of the same policies, the Four Asian Tigers (Korea, Taiwan, Singapore, and Hong Kong) all achieved growth rates consistently above 7% and lifted millions of citizens into the middle class. Finally, though China has diverged slightly in its economic reforms, many key elements of the development state have been critical to its ascendance, beginning with Deng Xiaoping. These impressive results have attracted emulation around the world, particularly in Southeast Asia and sub-Saharan Africa.

Successful developmental states were able to achieve high, sustained growth rates through a common playbook, including the following factors:

- First, governments took the lead in organizing market activity, as policymakers intervened to shape the allocation and composition of investment and address market failures.

- Industrial policies targeted fixed capital investments to certain sectors.

- At the same time, strategic liberalization and stable macroeconomic policies helped coordinate private sector expectations.[1]
- Bureaucrats were chosen through competitive, meritocratic procedures and enjoyed lucrative incentives that rewarded high performance. Pilot agencies such as the Ministry of International Trade and Industry (MITI) in Japan recruited the best and the brightest from top educational institutions and gave them influence across a range of economic policy issues.[2]

In this framework, key decisions often originated in an elite state bureaucracy that was insulated from political pressure. Notably, key exemplars of the developmental state model all had authoritarian regimes at the beginning of their growth stages. The concentration of power within the executive branch freed the bureaucracy from populist pressures,[3] helped ensure focus on longer-term economic goals, and better structured relations with private sector actors.

Russia's Flirtation with the Model

Russian politicians have not been immune to the charms of the developmental state model and have explicitly cited the experience of the Asian Tigers as helping guide their policy decisions. During his presidency, Dmitry Medvedev argued that Russian must follow the Singapore model, while ministers and governors have expressed reverence for Lee Kuan Yew. In late 2018, Putin remarked that "Singapore is a good model of development, including in the digital sphere … many issues are efficiently resolved, including social questions such as housing construction."[4] He made similar comments about China's economic modernization early in his first term in office.

This praise has translated into real policy action. Since the mid-2000s, the Russian government has selectively integrated various aspects of the developmental state model. First, nationalization of many of the country's most prized assets has led to the creation of large state corporations designed to integrate industrial bases and more efficiently compete on world markets. In this regard, Russia's approach parallels the networks of party-owned enterprises that both Taiwan (KMT Inc.) and China (CCP Inc.) built during their respective rises. State-owned banks have led the charge mobilizing the financial capital and providing easy access to government-backed loans. Much of the banking system is now in state hands; these banks have mobilized financial capital, providing easy access to government-backed loans, while the political system has been designed to prevent certain constituencies, such as labor unions or opposition parties, from raising objections.

Moreover, following Singapore's lead, the government has promoted high-profile meritocratic recruitment schemes such as the Golden Cadre Reserve under President Medvedev and the "Leaders of Russia" competition. Transparency has improved through digitalization and open data efforts, with new anti-corruption policies, such as financial disclosures and cadre rotations ramping up scrutiny (at least on paper). One of the Russian government's signature moves has been creating the Agency for Strategic Initiatives to facilitate investment, design road maps, and improve the country's business environment. This pilot agency mirrors moves taken by Japan to streamline advanced policy thinking under the auspices of a single group of bureaucrats.

Finally, the appeal of protecting and incubating certain industries has caught fire among policymakers looking to stimulate growth in tough international economic conditions. For instance, complex property rights and ownership restrictions in Russia make it difficult for multinationals to gain market share in Russia, effectively limiting the foreign footprint in Russia's economy. Moreover, particularly following international sanctions imposed beginning in 2014, policymakers have sought ways of stimulating growth: fierce protectionism, localization, and import substitution policies shield domestic producers and raise their competitiveness on world markets, from agricultural products to medicines and software. South Korea adopted a similar approach to much success starting in the 1950s.[5]

While these policies have met with varying results, the influence of the Asian developmental state model is undeniable.

Economic Underperformance and Growing Inequality

Yet the results of this selective and piecemeal approach to the developmental model have been underwhelming. Russia's growth rate has not budged above 2% in over a decade, as real earnings and consumer welfare have markedly declined.[6] Why hasn't the country's experiment with these reforms gone as planned?

The answer arrives from a closer examination of what went right in East Asia. Although few of the East Asian states ever fully eradicated corruption, developmental states thrived when businesses competed for favors from the government, rather than monopolizing political access and absorbing rents. Even when corruption persisted, outright graft was held in check.

In other words, bureaucrats and businesspeople struck a competitive balance in which each side held the other hostage from stealing too much and putting private interests too far over those of the state.[7] The lesson: by promoting mutually beneficial rivalry both between businesses and with elite bureaucrats, governments can hold corruption in check and ensure that public goods, such as property rights protection and infrastructure investment, still get provided.

There are several problems hindering Russian economic growth. These are primarily rooted in the entrenchment of elite and Putin's inner circle, a major reason that the state has failed to eradicate corruption; and the broader failure to support small and middle businesses, educational and entrepreneurial opportunities; and checks on inequality.

Elite corruption

In particular, the Russia case illustrates the pitfalls of allowing a small number of state-backed giants to stamp out private sector rivals and corner the most lucrative economic opportunities.[8] Political and economic elites have fused a durable consensus: subsidies and contracts go to the most politically connected rather than the most economically productive, while more dynamic businesses languish from inattention. Regulators look the other way as state corporations freely swallow smaller, more vulnerable private sector rivals. And lax capital controls have allowed the spoils of corruption to leave Russia for Western bank accounts and real estate assets, rather than being reinvested in the domestic economy as many East Asian developmental states demanded. Other authors have written further on the Russian state's corruption and criminal ties, referring to these practices as crony capitalism or kleptocracy.[9]

Moreover, an elite, insulated bureaucracy—free, in the developmental state model, to coordinate economic activity and limit the abuse of economic power by a select few—has not materialized in Russia. The few pockets of efficiency that have arisen are still dwarfed by the preponderance of officials entering government solely for self-enrichment, as public sector jobs are perceived by many as one of the few remaining ways to earn a steady income—and for some, the best opportunity to get rich quick.[10] The government has shied away from holding bad bureaucrats accountable, in part because corruption is so frequent, and in part because culling the ranks of inefficient and/or corrupt employees would markedly increase unemployment, as there are fewer and fewer stable employers in the private sector, especially outside of Moscow.

Constraints on small and medium businesses are another key factor. Unlike in East Asian markets, small- and medium-sized businesses in Russia have been largely sidelined from real discussions on how the economy should be managed. There is little clear communication between business and government about how to fix obstacles around product upgrading, allocating state investments, or identifying export markets. Without feedback mechanisms and information sharing, under-skilled bureaucrats unilaterally pick winners, often based on which offer the most lucrative personal incentive.

Human capital loss and inequality must also be taken into account. The closed political space and mistreatment of small entrepreneurs have propelled "brain drain," with many of Russia's brightest businesspeople, engineers, and other workers abroad, lured in by large Western firms hoping to capitalize on the Soviet legacy of STEM education. Without market competition and bureaucratic accountability, economic gains have accrued largely to the already wealthy and well-connected. Russia already ignominiously leads the world in inequality.[11] Its middle class has not grown significantly since the oil heydays of the mid 2000s. The state seems bent on reducing its welfare and redistributive commitments, particularly by reforming the pension system. Much like some of their counterparts in the U.S. and China, Russian leaders have chosen to downplay the persistent and growing gap between the rich and poor.

Finally, anger over political and economic inequality are fundamental to understanding the population's growing appetite for change. Discontent over different forms of exclusion is growing. Widespread use of fabricated drug and criminal charges have sparked outrage with an arbitrary judicial system that privileges the wealthy over the rule of law. Outside of Moscow, others see their investments in education not leading to respectable employment and worry that future opportunities for their children are worsening. People no longer believe that problems with infrastructure and health care stem from insufficient funds, but rather that insiders have siphoned off needed money along the way.

To be sure, the economic sanctions imposed by the United States and the European Union following Russia's annexation of Crimea in 2014 have taken their toll on Russia's economy, and the full economic impact of the Covid-19 pandemic has yet to be fully felt. Even given these external circumstances, it is overwhelmingly the aforementioned internal problems that have prevented Russia from successfully following the developmental state model or achieving economic growth through other means.

Policy Recommendations

U.S. policymakers have at times been slow to recognize the changes underfoot in Russia's economy. The next era of U.S. policy should partially rethink what economic engagement with Russia could look like in the Russian reality of wealth concentration and inequality.

1. The sanctions regime must be rethought. While potentially effective at curbing Russia's aggression abroad, sanctions have contributed to the business-government nexus rather than splitting off economic discontents who might advocate for political and economic reform. Many of the country's most powerful elites have calculated that their future economic prosperity will may be slightly smaller, but remains certain due to their redoubled commitment to Russia's crony capitalism. Those that thought differently quickly sold off their assets and left the domestic market. While lifting sanctions is not necessarily the answer, the current system is far from ideal.

2. Many of Russia's bureaucratic reforms offer new opportunities for dialogue with Western counterparts. The last decade has shown that competent, honest officials exist in certain parts of the Russian government, and that appetites for cross-border learning on the part of some of them have not waned, even as Russia's foreign policy has become more aggressive. The U.S. would be wise to develop stronger cooperation and encourage exchanges with existing nodes of meritocratic expertise within the Russian government.

3. Even with its dependence on natural resources, Russia's domestic market is still vast and diverse. Unfortunately, the playing field is tilted against the small- and medium-sized businesses that could serve as a bulwark against further political consolidation and economic

stagnation. The West needs to get creative about lowering the barriers to entry to institutions that could assist these companies in gaining a stronger and less politicized foothold in Russia's economy. These might include international arbitration courts, new forms of bank financing, or integration into global value chains.

4. Finally, the West, and the U.S. in particular, has turned a blind eye for too long to corrupt outflows from the Russian economy. Greedy intermediaries, such as lawyers and company formation agents, fail to conduct adequate due diligence on the billions of dollars leaving Russia every year. There is a strong argument to be made that reducing money laundering out of Russia would compel elites to reinvest in the domestic economy. Until the U.S. closes its own doors to suspicious, dirty money, allies in source countries have little chance to build more durable, inclusive institutions.

References

[1] Haggard, Stephan. *Developmental States.* Cambridge: Cambridge University Press, 2018.

[2] Johnson, Chalmers. *MITI and the Japanese Miracle: the Growth of Industrial Policy: 1925-1975.* Palo Alto: Stanford University Press, 1982.

[3] Haggard, Stephan. *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries.* Ithaca: Cornell University Press, 1990.

[4] Верницский, Антон. "Владимир Путин на пресс-конференции подвел итоги своего визита в Сингапур." Первый Канал. November 15, 2018.

[5] Haggard, Stephan, Byung-kook Kim, and Chung-in Moon. "The Transition to Export-led Growth in South Korea: 1954–1966." *The Journal of Asian Studies* 50.4 (1991): 850-873.

[6] Russia Economic Report. "Modest Growth Ahead." No. 39. Washington, DC: World Bank Group, 2018

[7] David C. Kang. *Crony capitalism: Corruption and development in South Korea and the Philippines.* Cambridge: Cambridge University Press, 2002.

[8] David Szakonyi. "Monopolies Rising: Consolidation in the Russian Economy," PONARS Policy Memo, No. 491. November 2017.

[9] See Karen Dawisha, *Putin's Kleptocracy: Who Owns Russia?* (New York: Simon and Shuster, 2014); Mikhail Zygar, *All the Kremlin's Men: Inside the Court of Vladimir Putin*, (New York: Public Affairs, 2016); Anders Åslund, *Russia's Crony Capitalism: The Path from Market Economy to Kleptocracy*, (New Haven: Yale University Press, 2019).

[10] Jordan Gans-Morse et al. "Self-Selection into Public Service in When Corruption is Widespread: Evidence from Post-Soviet Russia." *Northwestern University and Higher School of Economics Working Paper* (2018).

[11] Svetlana Saltonova, "Inequality in Russia" IQ Hse.ru (May 28, 2019).