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978-0-521-76810-8 - Invisible Hands, Russian Experience, and Social Science: Approaches to Understanding Systemic Failure

Stefan Hedlund

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## INVISIBLE HANDS, RUSSIAN EXPERIENCE, AND SOCIAL SCIENCE

This book investigates cases in which national and international activities have gone massively wrong, entailing seriously negative consequences, and in which the sophisticated analytical models of social science have ceased to be helpful. Illustrations range from the global financial crisis to the failure to achieve speedy systemic change in the Former Soviet Union and the failure to achieve development in the Third World. The analysis uses as a backdrop long-term Russian history and short-term Russian encounters with unrestrained capitalism to develop a framework that is based in the so-called new institutionalism. Understanding the causes of systemic failure is shown to require an approach that spans the increasingly specialized subdisciplines of modern social science. Demonstrating that increasing theoretical sophistication has been bought at the price of a loss of perspective and the need for sensitivity to the role of cultural and historical specificity, the book pleads the case for a new departure in seeking to model the motives for human action.

Stefan Hedlund was appointed professor of Soviet and East European Studies at Uppsala University in 1990. Over the years since then, he has published extensively on the breakup of the Soviet order, on attempted Russian reforms, and on the importance of historical legacies. Professor Hedlund has been a frequent commentator in the media and has traveled and lectured widely; he has spent two sabbatical semesters at Harvard University as well as briefer stays at the Kennan Institute and George Washington University in Washington, D.C.; Stanford University; and Hokkaido University in Sapporo, Japan. His most recent publications include *Russian Path Dependence* (2005), *Russia since 1980* (Cambridge University Press, with Steven Rosefielde, 2009), and *Authoritarian Market Economy* (Chinese edition, 2011).

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*For Lilian, with love,  
as always*

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# Invisible Hands, Russian Experience, and Social Science

*Approaches to Understanding Systemic Failure*

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## Preface

Things will and do at times go wrong, and actions taken will at times have unintended consequences. As such there is nothing at all remarkable in any of this. Things that go wrong will most often work themselves out on their own, and unintended consequences will most often be compensated for by other action. What has prompted the writing of this book is a growing realization of the significance to social science theorizing of cases where none of this is true, that is, where things go wrong to the point that systemic mechanisms of self-correction break down and the analytical models of social science cease to be helpful.

The essence of the argument is that such extraordinary cases of systemic failure represent causal chains of events that may be fully understood only by taking into account a wide range of factors that are no longer possible to house in toto within any of the increasingly specialized subdisciplines of modern social science. The reasons for the latter are simple and essentially represent a trade-off. Increasing theoretical sophistication has been bought at the price of a loss of perspective and of sensitivity to the controversial roles of cultural and historical specificity. In routine situations of marginal change, the benefits of this development clearly outweigh the costs. In cases, however, of major societal transformations that result in systemic failure, an important part of the problem will be that impressions of theoretical sophistication have produced overconfidence in the powers of prediction and of political action to achieve anticipated goals.

To illustrate these rather bold claims we may recall the fall of the Berlin Wall, a momentous event that was widely perceived – at the time – as the dawn of a new era. The effective end of the Cold War was expected to bring in its wake a whole slew of good things, ranging from the “peace dividend” that would result from paring down military forces and the economic gains that would be derived from a transition from planned to market economy,

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to a new climate of fruitful international cooperation, and – especially – a new role for a Europe no longer divided by an Iron Curtain.

The high point on the latter count was marked in December 1991. Meeting in the small Dutch town of Maastricht, European leaders proudly agreed to launch their grand project of building a European Union (EU). Tacitly patterned as a United States of Europe, the EU would not only have its own parliament, its own government, and its own constitution. Most important, it would also have its own currency, to be supervised by a European Central Bank. The days when Henry Kissinger could quip about the absence of a phone number on which to contact Europe would be finally over.

Counting from the time of German unification in October 1990, the two decades that followed would bring home two essential and highly painful lessons. The first teaches what was hinted at earlier, namely, that things do not always take care of themselves, at least not with generally desirable outcomes. While deregulation, for example, may be essential for market economy, it carries no guarantee that the outcome will be good economic performance, and while holding elections may be essential to a democratic system, it carries no guarantee that the outcome will be democracy. The second lesson is that even if system managers do recognize that policy intervention may at times be critically needed, they will face serious limitations on what can be achieved, and they will run serious risks that actions taken will produce outcomes that differ greatly from those intended.

Both of these may at first appear to be rather trivial. Yet, as will be argued throughout this book, many of the bad things that happen in this world can be led back to a failure to consider the deeper message that is embedded here. As further illustration, we shall advance four cataclysmic events that were played out over the two decades from 1991 until 2010. All will serve to underline the need for a new departure not only in policy making but also, and perhaps more important, for a new departure in those social sciences that claim to underpin the making of good policy and the building of good society.

The first of these events was the sudden collapse of Soviet power, which in a stroke redrew the global security architecture. Entailing the end of three artificially created federations – in addition to the USSR also those of Yugoslavia and Czechoslovakia – it brought in its wake dissolution of the Warsaw Pact of military cooperation and of the COMECON association for economic cooperation among socialist states within the Soviet sphere of interest. Two dimensions of the ensuing process of adaptation are of particular importance.

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An immediate consequence of the “democratic revolutions” that spread across Central Europe was loud calls for national self-determination. Once so proudly touted by Woodrow Wilson, in his fourteen-points speech to the U.S. Congress, such calls would now be associated with virulent nationalism that in some cases resulted in ethnic tension, ethnic cleansing, and bloody civil wars. Given the clearly instrumental way in which aspects of culture and history played into the process, with at times disastrous outcomes, the lesson was that state-building turned out not to be so easy after all, and clearly not something that could be simply left to its own devices.

In a less spectacular dimension, the ambitions to embark on a “transition,” away from central planning and communist rule, would again illustrate that matters at hand were vastly more complex than had been anticipated. The end of Soviet power also marked the end of a distinctive social order, resting on institutions that were introduced to suppress democracy, market economy, and the rule of law. Early beliefs that post-Soviet reconstruction could proceed by simply rebooting the system failed to consider that over time those institutions had become associated with norms, beliefs, and expectations that by the time of dissolution were deeply embedded. They would in consequence not be easily amenable to deliberate change by simply rewriting the formal rules of the game.

The second of our four events was the U.S.-led invasion of Iraq in March 2003. Representing a breach of international law (probably), it also served to create deep ruptures within the alliance of Western powers (definitely). Ignoring all speculation about the role of oil as a motivating force, there can be little doubt that those who pleaded for the operation had wider ambitions than simply ridding the world of Saddam Hussein and the weapons of mass destruction that he was alleged to possess.

The grand ambition was that by introducing democracy in Iraq, a host of despotic regimes in the Arab world would come under intense pressure to follow suit. The world in consequence would come to witness a new wave of democratization, coupled with the emergence of successful market economies that promised tantalizing opportunities for new business. As we now know, it did not work out quite like that. The effective outcome instead was to strengthen Iran, to destabilize Pakistan, to aggravate even further the Arab-Israeli conflict, and to give Al Qaeda a greatly expanded role.

The message again has much to do with the role of culture and history, as determinants of the functioning of clan-based societies and as forces of motivation for deep-rooted antagonisms between Islam and the Western world. At stake here was the presumed universality of Western values. The vision in itself was very clear. If only given the opportunity, all the nations



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of this world would gladly opt for the type of social order that has evolved in Western Europe and North America and in a few outliers. From a social science perspective, this brought into question some truly fundamental issues. Following widely acclaimed approaches of agency and functionalism, the task was seen to be to simply create opportunity and good things would follow. Well, they did not and lessons are due to be learned.

The third event was the global financial crisis that erupted in September 2008, conveniently dated to and associated with the collapse of the venerable investment firm Lehman Brothers. The shock and awe produced by this event provided sordid insights into the myopic worldview of financial markets and of government agencies responsible for oversight and policy management. The valuable time that was lost debating whether it really *was* a crisis may be taken as a first indication of the price that would have to be paid for failing to understand how markets really work.

What produced the crisis was a combination of hard and soft factors. On the former count we may note a string of legislation designed to liberate markets and thus to allegedly improve their performance. While all of this represented necessary conditions for the crisis to occur, none was also sufficient. What really made the crisis possible was the long wave of neo-liberal ideology of privatization and deregulation that was inspired by Milton Friedman and implemented by politicians following the lead of Margaret Thatcher and Ronald Reagan.

Reflected here is a need to draw a line between legitimate self-interest, without which no market economy will be possible, and the presence of endemic human greed, which constitutes by far the most serious threat to the functioning of markets. While the outbreak of the crisis could in a technical sense be led back to actions such as the 1999 repeal of the (Glass-Steagall) Banking Act of 1933, the fundamental cause was the accelerating erosion of norms of self-restraint that went hand in hand with the emergence of a public culture of hard-nosed individualism. The question that emerges here is how the social sciences should model *homo economicus* and what the implications are for the pursuit of economic and other policies. Subsequent chapters will have much to say on these issues.

The fourth and final event is the renewed financial crisis that erupted in April 2010, when it suddenly dawned on European leaders just how close Greece was to state bankruptcy. Placing into focus the visions of European hubris that were expressed at Maastricht, the Greek crisis brought home two points. One was that critics had been right in pointing at the incompatibility between a common monetary policy and national fiscal policies, and the second that we live in a world where politics and vested interests

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will always trump ambitions to enforce formal rules that somehow get in the way.

In purely technical terms, it did look as though a solution had been found. The Stability and Growth Pact of 1997 was introduced to ensure that no member of the euro zone would be allowed to exceed set limits on public debt and on budget deficit as shares of gross domestic product (GDP). If all governments had abided by their commitments, all might have been well. The only problem was that governments look to their own interests first, and if those governments represent major powers then their breaches will go unpunished. Given that in the years preceding the crisis both Germany and France had been allowed to openly flaunt the Stability Pact with impunity, there seems to be some poetic justice in the fact that when Greece needed rescue they were the ones that would have to pay the highest price. What is reflected here is a serious problem of moral hazard, of leading governments into temptation to cheat and cook their books, and creditors to play along with obfuscation, all in the belief that in the end, when needed, help will be made available courtesy of the taxpayers.

Arriving on the heels of the global financial crisis, at a time when fragile recovery was seen to be on the way, the Greek crisis added renewed suffering to populations that again had no share in the blame. Recalling previous outbursts of anger about governments preferring to bail out bankers rather than households, it was revealing that the option of restructuring the credits so lavishly provided by bankers to Greece, while the going was good, was not even placed on the agenda. Protecting those who really were at fault remained a priority.

The notion of “systemic failure” will be used in the following to describe events of precisely these kinds and magnitudes. Looking back at what happened during the two decades under consideration, we will come away with impressions of outcomes that are widely different from the expectations that prevailed at the time when the new era dawned. The damage that has been done is substantial, and there is nothing to say that the books may at any time soon be closed on any of the four processes that have been outlined here.

This should certainly not be taken to imply that the world is coming to an end. In a long-run perspective there is nothing at all unique in any of this. History is replete with cases of financial crisis, of ethnic violence and civil wars, and of misguided government interventions aiming to implement change. What does make it all worth considering more closely is that the outcomes stand in such sharp contrast to initial expectations, and that we are still in a learning mode seeking to grasp what happened and why it happened.

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As noted at the outset, our more specific understanding of “systemic failure” shall be set aside from the simple facts that things often do go wrong and that policies often do have unintended consequences. In most such cases, this is trivial and negative effects will somehow be ironed out by themselves. What we are concerned with here is different, namely, cases where things go massively wrong, and where systems and system managers fail to cope. The approach will be broad, in the sense of taking into consideration processes that are played out over the long run, over the medium term, and in the very short term.

Beginning with the long term, we shall be looking at cases of persistent failure to break out of suboptimal institutional solutions. This may be manifested in protracted historical processes of divergence between countries in economic development paths, as well as in more recent failures to escape poverty traps and infelicitous constellations of power that produce predatory regimes. The core challenge is that so many of these have proven so resistant to even determined ambitions to achieve change. The track record of foreign aid in the post-World War II era is, for example, not a happy one. Seeking to atone for colonialism, rich countries have put up massive amounts of aid but achieved little in the way of results. Structural adjustment programs and the like have been based on agency and functionalism, with little to show in terms of sustained reductions of deprivation. While some countries have succeeded in breaking out of poverty, notably China, they have as a rule not been the ones most heavily pampered by outside assistance.

In the medium term, we have two decades of ambitions by countries in the central and eastern parts of Europe to achieve a “transition” to democracy, market economy, and the rule of law. Given the wide variety of outcomes, we again have reason to question the assumption of universality. The agency approach of the “Washington Consensus” was limited to setting a few parameters, such as “getting the property rights right,” and then to wait for the market to do the rest. The very fact that social science remains embroiled in debate over what went wrong and why, and indeed even over whether anything really *did* go wrong, shows that we are faced here with an issue of fundamental importance. Again it is also the case that those who have performed the best have as a rule not been those that were the most favored by outside advice and assistance – the case of Russia offering an outstanding illustration.

In the short term, we have the global financial crisis and the ensuing Greek turmoil. Both are stunning not only in the huge size of the losses and the political disruptions involved, but even more because both apparently

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arrived as total surprises to system managers. With the exception of a few whistleblowers, who were easily and conveniently ignored, nobody in positions of power saw it coming, on either occasion. Given the massive industry that has emerged to predict and forecast what markets will do, this is not a happy verdict. When push came to shove, when serious prediction and forecasting were most desperately needed, the systems failed. The fact that it has all happened so many times before, albeit perhaps not on the presently global scale, and that the same will likely happen many times again in the future illustrates that we are looking here at an endemic problem of quite some magnitude and significance.

Our approach to grappling with the issues laid out here is divided into three interwoven themes. One concerns the belief in notions of invisible hands that are assumed to guide action in socially desirable directions. The next holds up the role of Russian experience as a vital source of illustration, and the third will investigate what implications may be seen for social science theorizing.

Beginning with the belief in invisible hands that was famously introduced by Adam Smith, there has been a strong tendency in the liberal tradition to believe that things will indeed work themselves out – if only governments can be kept at bay. Quite in line with the agency approach, deregulating markets will generate good economic performance, holding elections will ensure democracy, and writing laws will produce the rule of law.

The problems that are encountered here move on two levels. One is that of individual actors, where reasonable assumptions about self-interest produce less obvious conclusions regarding the congruence between individual and collective good. While it has been recognized that such congruence may not always be at hand, deviations have often been regarded as aberrations that will iron themselves out. Little attention has in consequence been paid to such types of motivation for action that will determine the choice between rule-abiding and rule-evading behavior.

At the level of government we may find a similar belief in self-interest that drives governments to maximize the collective good, entailing ambitions to optimize taxation over time and to provide an optimal supply of public goods that may enhance the performance of markets. All will be consistent with ideals of accountability, transparency, and good governance. Again, however, we must take into account the presence of temptations to place narrow self-interest before the common good. The core question concerns what may cause governments to deviate from the good path and to proceed instead down a road that leads – in the extreme – toward predation and outright kleptocracy.

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The challenge on both counts is to model the circumstances under which action will be taken that is consistent with or in contradiction to the collective good. If motivation for action is to be portrayed in terms of invisible hands, logic demands that such portrayal must include both options. In neither case may we talk of forces of nature, or of genetic predisposition, but merely of the presence of norms, beliefs, and expectations that are embedded in traditions, in collective memories, and in “culture” very broadly defined. While the wide attraction of presenting correlations between differences in economic performance and differences in soft variables such as religion may be taken as evidence that “culture matters,” it still leaves open questions of causation and of remediability.

The second of our three themes is that of Russian historical experience, which will be used as a rich source of illustration. Four important reasons motivate this choice. One is that Russia has a long tradition of governance that has been distinctly market-contrary, serving to illustrate what may happen at the level of individual action when government interdicts freely negotiated horizontal contracting. Another is that there is an equally long tradition of change being implemented by intervention from above, with little or no participation from below, serving to illustrate limitations to the agency approach of undertaking political interventions. The third is that we have repeated cases both of state collapse (in 1598, 1917, and 1991) and of financial market collapse (in 1998), which may add to our understanding of the causes of systemic failure. The fourth and final reason to bring Russian experience into the account is that the presence of deep historical roots, going back to the fifteenth century and earlier, may help shed further light on theories of path dependence.

Our third overriding theme concerns the role of social science theorizing. It constitutes the mainstay of the account as a whole and is designed to blend lessons derived from the first two themes into a broad understanding of what causes systemic failure and what implications may be seen for how such causes should be understood. The core challenge rests in understanding motivation for action, which at the individual level may be viewed as a choice between work and shirk, or between value adding and purely redistributive activities. At the level of government, a distinction between rent *seeking* and rent *granting* may serve to illustrate how the provision of preferential treatment becomes embedded into personalized network relations, with negative implications for governance.

In general terms, it may be recognized that notions such as *homo economicus*, *homo politicus*, *homo sociologicus*, and indeed *homo sovieticus*, serve as convenient shorthand for sets of core assumptions that define the

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approaches of different social sciences. Building on what was said earlier about invisible hands, two theoretical challenges emerge. One is that these sets of core assumptions differ fundamentally on issues relating to individual action. Should action be modeled as instrumentally rational and forward looking, or as the result of individuals being captives of the past, mindless playthings with little or no latitude for deliberate choice? The other concerns the crucial importance of identifying what components of the institutional context of transactions will determine whether individuals will opt for rule-obedient or rule-evasive actions. Under what conditions may such choices cluster in the latter direction, to the extent that systemic failure results?

The argument will begin with an introductory *tour d'horizon* that covers the global financial crisis, placed into the context of prior discussions on crises of capitalism, and the preceding Russian hyperdepression, viewed as illustration of what may happen when markets are suddenly liberated. The main purpose in providing this broad empirical background will be to set the tone for appreciating the full gravity of the problems that will be dealt with in the subsequent account.

Work on this book was begun in 2007, during a sabbatical semester at Harvard University's Davis Center for Russian and Eurasian Studies. I went there with the stated intention of writing a book about new institutionalism and the presence of reform-resistant institutions, as revealed by the complexities of post-Soviet transition. Although the scope of the book would subsequently be broadened and redefined, much of the essential groundwork was done during this stay. My gratitude to the Davis Center, and to friends and colleagues in residence there, is, as on previous occasions, deep and warmly felt. Special thanks must go to Tim Colton, Marshall Goldman, Loren Graham, Mark Kramer, Tom Owen, Richard Pipes, Tom Simons, and Lis Tarlow.

Time to rethink and refocus was provided by a generous grant from the Kennan Institute at the Woodrow Wilson Center, allowing me to spend a month in Washington, D.C., in the spring of 2008, at which time I also enjoyed the generous hospitality of the Institute for Russian, European and Eurasian Studies at George Washington University. Thanks go to Blair Ruble and especially to James Millar, an old and dear friend who is regrettably no longer among us. A final word of thanks must also go to Roland Hsui at Stanford University's Freeman Spogli Institute, where I enjoyed a brief but very productive stay as Anna Lindh scholar in December 2009.

Numerous colleagues have assisted in shepherding me along the path of rethinking and rewriting. Included here are four anonymous referees, tasked

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with reading the first book proposal submitted for review by Cambridge University Press and with commenting on my responses. Thanks in this context also go to Scott Parris, my editor at Cambridge, who has patiently maintained faith that my rewrites would in the end be worthwhile. Among those who have generously taken time to read the manuscript in full, and whose comments have been most valuable, special thanks must go to Archie Brown, Jukka Gronow, Philip Hanson, Eugene Huskey, David Lane, Thomas Owen, Richard Rose, and Heinrich Vogel. Finally, I also thank Nilay Akcamak for valuable research assistance and for help in preparing the index.

With due credit thus acknowledged, and with the usual proviso about accepting responsibility for all remaining errors and omissions, we may now proceed to the world of financial markets, a world where movements are swift and memories short, and where the mortal sin of greed may, at times of great hubris, even be touted as inherently good.