Chechnya and the Economic Consequences of Secession

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The following is a summary of a talk he gave at the World Policy Institute in New York City on 14 November 1998. The talk was part of a seminar series sponsored by the Eurasia Group on the political economy of secession. Dr. Walker was asked to speak about the economic ramifications of Chechnya's possible secession from Russia.

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Contrary to popular assumptions, it cannot be assumed that secession always leads to net economic costs, especially in the long-run. If accompanied by significant violence, secession will likely prove very costly indeed, both in human lives and in losses of economic infrastructure and productive activity. But while there are inevitably some short-term costs of separating from an existing state, the net economic effects may well be positive, not only for the seceding territory but also for the rump state, particularly in the long-run. This is true for two reasons. First, peaceful secession may avoid bloodshed in defense of territorial integrity. And second—and this will be the main focus of my talk today—the economic consequences of peaceful secession are almost entirely a function of the policies, institutions, and background conditions in the seceding and rump state before and after secession. Economic theory, as well as empirical observation, suggests that open economies do better than closed economies in the long-run. In particular, there is little disagreement among professional economists about the long-term net welfare gains from free trade, although the distributional effects of free trade are various and the economic benefits of fully open capital and labor markets are more controversial. If secession results in significant increases in barriers to trade (or, arguably, to the free flow of capital and labor as well), or to significant increases in transaction costs generally, it will likely lead to net losses for both economies. But in principle, it is quite possible that secession could be effected with minimal increases in trade barriers and transactions costs, depending upon the kinds of institutions and policies that are adopted by the governments in question.

Indeed, the institutions and policies that can put into effect after secession are infinitely varied. Consider, for example, the question of national currencies and monetary policy. Both parties might agree (1) to use the old national currency (as was the case initially with the ruble after the USSR's dissolution); (2) to peg the exchange rate of a new currency in the seceding state to the national currency of the rump state; (3) to adopt a supra-national currency like the Euro, or (4) to peg both currencies to a third one like the dollar. Even where two entirely independent currencies are established, it may be that the post-secession arrangement is economically advantageous because the two new currency regimes are closer to what economists call "optimal currency areas." As the long and contentious debate over the Euro suggests, it is not even clear that in Western Europe, where governments have had centuries of experience with capitalism and where institutional and macro-economic differences are comparatively moderate, the eleven EU "Euro-states" will be better off adopting the currency than, for example, the United Kingdom, which has opted out. Where you have significant disparities in economic conditions—for example, between northern and southern Italy, or between the Czech republic and Slovakia—or where you have regions that are out-of-sync in terms of their business cycles, as is the case with Ireland and Germany today—it may be that the countries involved would be better off with two different currencies and separate central banks that can adopt independent monetary policies to cope with external shocks or unsynchronized business cycles.

Likewise it is impossible to generalize about the effects of secession on levels of taxation and government expenditures. Secession may simply mean that the seceding party continues to have fiscal autonomy but no longer pays taxes to an ineffectual national government of which it is no longer a part. The result would then be a decrease in taxes but no deterioration in government services. Alternatively, where the national tax burden is minimal and secession forces the government of the seceding state to incur additional expenses (for example, on national defense), government expenditures and taxes might go up considerably.

In principle, even transaction costs on trade and investment between the seceding territory and the rump national state could decline after secession. There are often considerable barriers to trade between regions in large countries, particularly ones that are suffering from internal turmoil (as is the case in Russia today). One cannot assume, therefore, that those barriers would increase after secession, particularly when secession results in greater internal order or diminished corruption. If formal or informal barriers to trade do not increase significantly, and if, for example, the two governments involved find it easier to coordinate legislation and harmonize commercial codes and other laws after secession, it may even be that businesses engaged in trade or investing in both areas discover that the costs of doing business decline.

Above all, it may be that political and economic uncertainly is diminished by peaceful secession. Consider Quebec. Investors hate uncertainty, especially when they are not sure of the consequences of some dramatic event such as Quebec's secession. One could credibly argue, therefore, that the greater economic cost to Quebec is the endless threat of secession and the exaggerated fear of its consequences among investors—better just to have done with it, put the uncertainty behind you, and incur the up-front costs of secession in the interest of long-term stability and greater certainty.

Similarly, it may be that a national government that confronts a secession crisis is paralyzed by the challenge and is unable to muster the political will to bring down inflation or free-up labor markets, something that might be possible were secession to unblock the political impasse. This, for example, was almost certainly the case for the Baltic states after the dissolution of the USSR. (Although I should note that the Baltic states deny that they were seceding on the grounds that their incorporation into the USSR had been illegal from the start, an interpretation shared by most Western governments.) For Estonia, Latvia, and Lithuania, it is hard to deny that secession had enormous medium and long term benefits, even if the short-term costs of reorienting their economies westward were considerable, above all because independence meant that they were no longer burdened by the ineffective economic policies coming out of Moscow.

It is even arguable that the secession of the Baltic states was beneficial to some or all of the other successor states. Had it not been for the successful sovereignty drives of the Baltic states, the USSR might well have remained intact, and the union republics might then have been subject to endless wrangling over the hybrid "socialist market" that Gorbachev and his allies were so committed to, with all is consequent economic costs. Certainly this is debatable, but so, too, is the widespread assumption, particularly in Russia today, that the dissolution of the USSR was an unmitigated economic disaster. If that were clearly the case, then the countries that were the most dependent upon inter-republic trade in the Soviet period should have fared worse after the breakup, which has certainly not been the case. The least dependent was the RSFSR (Russia), while Estonia, Latvia, and Lithuania were among the most dependent (inter-republic trade was almost twice as much of their output in 1988 as Russia's), and Russia's economic performance since 1991 has been much worse than economic performance in the Baltic states. Indeed, I suspect that the fragmentation of the USSR, despite its disruption of trade, relieved the economies of the region of the economic costs of trying to govern such a disparate collection of union republics with such different economic profiles. If so, the dissolution may well have been a necessary, albeit hardly a sufficient condition for economic recovery.

In practice, of course, there are almost always substantial short-term costs to secession, above all because secession is usually accompanied by significant violence or full-scale war. Even where secession or dissolution is effected peacefully, however, as was the case with Czechoslovakia and for the most part with the USSR (and which presumably will be the case if Quebec ever secedes from Canada), there are invariably very difficult economic problems that must be addressed, such as apportioning public and foreign debts, ownership of public assets, and so on. There are also costs that have to be incurred by the seceding state—for example, costs associated with establishing a new foreign ministry and foreign embassies and missions abroad, or (if necessary) developing a credible national defense capacity. There are also costs associated with belonging to assorted international organizations, including not only the United Nations and regional organizations such as NAFTA or ASEAN, but also institutions such as the International Telecommunications Union, the Universal Postal Union, the World Meteorological Organization; and the International Civil Aviation Organization, costs that can be significant for small and less wealthy states in particular. And in most cases, new barriers to trade and increased transaction costs emerge in one form or another. For example, secessions often lead to new customs regimes and tariffs on trade between the new and the rump states, while new legal regimes may substantially increase the costs of doing business in the two states. Finally, there are also economic costs associated with uncertainty and fear of potential conflict, which may persist even after a seceding territory receives international recognition, particularly if there is a perceived risk of conflict with the rump state.

In short, the economic consequences of secession vary substantially between cases, and there is no way to tell *a priori* what the net gains or losses will be for either or both parties over any particular time frame, let alone in perpetuity. So what does this, or economic theory generally, tell us about the economic consequences of Chechnya's possible independence from Russia?

An initial point is that size (for the most part) doesn't matter, at least economically. A great many small states are extremely prosperous—consider Luxembourg, which by some counts is the richest country per capita in Europe, or Monaco, San Marino, Liechtenstein, and Singapore. In contrast, many large states—for example, Congo, Nigeria, Brazil, India, and indeed Russia itself, to name but a few—have very poor records of economic performance. Numerous studies show almost no relationship between the size of a state, either in terms of territory or population, and economic performance.

Thus the oft-heard argument that certain areas, such as Chechnya, are too small to become independent is without merit. So too is the equally common assertion that certain regions cannot afford independence simply because they lack of natural resources (an argument that was frequently made about the Baltic states before the USSR's dissolution). Again, there is no clear relationship between natural resource endowments and economic performance. Consider resource rich countries such as Russia, Nigeria, or Congo, on the one hand, and resource poor countries such as Japan, Taiwan, or South Korea on the other. To be sure, a certain territory may not be *politically* viable as an independent state—hostile neighbors may make normal trade relations impossible. And it may be that a particular area is economically disadvantaged by virtue of its distance from world trade centers. But economically, size is largely irrelevant. And politically, the important point is that all small states are vulnerable to political pressure and intimidation from larger states, which merely suggests that it behooves them to get along with their neighbors or find some powerful allies.

To a large extent, all of this is irrelevant to Chechnya, for the obvious reason that its drive for independence has not been peaceful. In fact, Chechnya's economy is in ruins, and its prospects for rapid recovery are very poor. The war has destroyed the republic's economic infrastructure; its capital, Djokhar (formerly Grozny), has been all but leveled; unemployment is estimated by the government to be over 90 percent; better educated Chechens have mostly fled; the Chechen authorities are unable to secure internal order; and revenues from the oil pipeline running through the region will be modest under the best of circumstances. Nor is Chechnya likely to receive much financial support from Russia or the international community, at least for the time being. Even before its financial meltdown in August, Moscow lacked the financial wherewithal to provide Chechnya with substantial economic aid. It is even less able to do so now. The Russian political elite is also deeply divided about Chechnya, including in regard to the crucial question of whether helping Chechnya is in Russia's interest. Despite frequent appeals from various Russian specialists, it is therefore very unlikely that a "concept" or coherent policy for the North Caucasus generally, or for Chechnya particularly, will be adopted and implemented by the Russian government.

Neither is the international community likely to help very much, not only because of concerns about Russian sovereignty but because Chechnya appears to be entirely unable to absorb outside aid effectively. The militarized Chechen elite, which was unified in its opposition to Moscow during the war, has fragmented, and the legitimacy of the Maskhadov government is being challenged today by opposition figures such as the influential field commanders Salman Raduev and Shamil Basayev, the former acting Chechen president, Zelimkhan Yandarbiyev, and Maskhadov's former foreign minister, Movladi Udugov. Most alarmingly, kidnappings have become ever more frequent. In 1998, over 150 kidnappings for ransom reportedly took place in Chechnya and surrounding regions, and the Chechen government seems unable to bring the epidemic to a halt. International humanitarian organizations, NGOs, and foreign governments were particularly horrified and chastened by the assassination of six Red Cross workers in the republic in 1997, the kidnappings and rape of foreign aid workers, and more recently the decapitations of three Britishers and a New Zealander who had been working for a British company that had been contracted by the Chechen government to install telephone lines in the republic. International organizations and NGOs have understandably refused to operate within the republic under these conditions. Until order is restored, this is unlikely to change. But even then, there would be considerable concern among foreign donors that humanitarian aid or financial support would disappear into the hands of criminals or corrupt Russian and Chechen officials. Moreover, as long as humanitarian agencies and international aid donors are unwilling to operate in the region, significant foreign direct investment is out of the question.

To conclude, I am sadly very pessimistic about Chechnya's economic prospects, although my pessimism has very little to do with general propositions about the economic consequences of secession or about the long-run economic "viability" of Chechnya as an independent state. The real problem is that the internal political situation in the republic is deteriorating, while relations between Moscow and Chechnya are unlikely to improve significantly, above all because they are unlikely to reach agreement on the republic's status. This will make it all the more difficult for the international community to provide significant aid, which is unlikely regardless as long as the Chechen government is unable to establish internal order. And even then, Russia's deteriorating economy, other strains on the global financial system, and the geographical isolation of Chechnya will make international support for Chechnya limited at best.

If there is a ray of hope for Chechnya's economy, it is that the Chechens are an industrious and resilient people who have devised effective coping strategies for dealing with harsh economic conditions through subsistence farming, trading, small-scale industry, and other "informal" commercial activities. Chechen authorities also appear to be generally realistic about the poor prospects for help from the outside and the need to rely on internal resources for recovery. Nevertheless, it is very unlikely that the Chechen economy will recover quickly, and, for this and other reasons, the republic will almost certainly remain a region of instability and unrest for years to come.

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