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Russian Rationality: Understanding Sanctions and Decision-Making Processes in Russia

By Rebecca L. Smith, *Arcadia University*

Introduction

In March 2014, the approximately two million people living in the Ukrainian peninsula of Crimea were 'reunified' with Russia.¹ The international community responded by placing sanctions on Russia to persuade the state into changing its policy toward Crimea and Ukraine. Sanctions are a tool used by states and intergovernmental bodies typically designed to "coerce, deter, punish, or shame entities that endanger their interests or violate international norms of behavior".² However, the sanctions do not appear to have caused any change in Russia's foreign policy actions to date. This begs the question; how might one best understand Russian foreign policy decision-making concerning Crimea and their response to the retaliatory economic sanctions? To examine this, I use expected utility theory and prospect theory – two psychological theories that have been adapted to economics and international relations. Following a discussion of each theory and the explanation each offers for decision-making behavior, I apply each theory to pertinent speeches and events to investigate which theory offers the best explanation for Russian foreign policy decision-making. Ultimately, I conclude that prospect theory offers the best framework for understanding Russian foreign policy decision-making

behavior vis-à-vis Crimea and the economic sanctions. An improved understanding of how states make decisions with respect to sanctions is useful in contributing to the overall debate about whether sanctions are an effective tool to provoke change from other states.

Background

On March 16, 2014, in a referendum condemned by the West as illegitimate, 97% of voters in Crimea voted to secede from Ukraine and join the Russian Federation. Following the referendum, leaders of Western states, including the U.S. and EU member states, warned Russian President Vladimir Putin against absorbing Crimea into the Russian Federation and imposed a travel ban and asset freezes on key Russian officials to deter such action. Despite the warnings and outrage at potential violation of Ukrainian sovereignty, President Putin signed a bill to annex Crimea into Russia on March 18, 2014.³ Official sanctions on Russia soon followed from the EU, US, and a host of other countries, including Australia, Iceland, Japan, and Norway. Many of these countries are Russia's largest trading partners.⁴

States have since scaled up the sanctions several times in addition to blacklisting several senior Russian officials and select companies. These sanctions specifically target the

¹Macias, Amanda. "A Detailed Look at How Russia Annexed Crimea," *Business Insider* (2015): n.p.

²Masters, Johnathan. "What are Economic Sanctions," *Council on Foreign Relations* (2015): n.p.

³"Ukraine Crisis Timeline," *BBC News* (2015): n.p., accessed November 12, 2015.

⁴Dreyer, Iana and Nicu, Popescu. "Do Sanctions Against Russia Work?" European Union Institute for Security Studies, December 2014, 1.

businesses and people closest to decision-making power in Russia. The main focuses are state finances, oil firms, and the arms sector. The EU and US also chose to target specific individuals and companies with connections to President Putin's inner circle.⁵ Overall, sanctioning states aim to place sanctions severe enough that they will encourage a change in Russian policy, but narrow enough that they harm those closest to Russian decision-making power rather than the average Russian. These sanctions have contributed to the current political and economic climate confronting decision-makers in Russia today.

Theory

The implementation of these sanctions has sparked a debate over whether sanctions work, and more narrowly, whether sanctions work on Russia. This debate revolves around two central themes: the extent of economic impact on Moscow and whether the sanctions are enough to change Russia's behavior.⁶ However, an examination of Moscow's view towards the sanctions is missing from this discussion. It is important to understand the Russian perspective, since the real decision-making power for change rests with Moscow. This section, therefore, offers two theories that may be useful in understanding Russian decision-making behavior with respect to the economic sanctions. The fundamental point of contention within these theories revolves around the idea of rational choice.

Expected Utility Theory

One theory that may help explain Russian foreign policy decision-making behavior with respect to economic sanctions is expected utility theory (EUT). EUT assumes two fundamental aspects about decision makers. First, it accepts that actors are rational, and therefore make logical decisions to maximize their benefit. Second, EUT assumes that actors consider the probability of possible outcomes. When dealing with uncertain outcomes, EUT states that decision makers will consider various options based on each option's expected utility.⁷

There are five central axioms that sum up the core of EUT:

1. Decision makers are rational. Actors order various outcomes in terms of preferences.
2. This order of preferences is transitive. Actors will rank preferences so that A is a more favored outcome than B, which the actor prefers to C, D, E, and so forth. If the cost of preference A outweighs its benefits, a rational actor would choose option B.
3. Decision makers know the subjective value, or the utility, of their actions.
4. Actors consider outcomes through examining both the utility of the outcome and the probability of success.
5. Decision makers always select the option with the greatest expected utility.

⁵"How far do EU-US sanctions on Russia go?" *BBC News* (2014): n.p., accessed November 18, 2015.

⁶Dreyer and Popescu, "Do Sanctions against Russia work?," 1.

⁷Mongin, Philippe. "Expected Utility Theory," in *Handbook of Economic Methodology*, edited by John. B. Davis, D. Wade Hands, and Uskali Mäki (Edward Elgar, London, 1997): 342.

⁸Bueno, Bruce de Mesquita, "The Contribution of Expected-Utility Theory to the Study of International Conflict," in *Handbook of War Studies*, edited by Manus I. Midlarsky (Routledge, New York, 1989): 144.

This theory is consistent with the logic behind implementing economic sanctions. The sanctioning party or parties inherently assume the rationality of the target and that negotiations will follow the sanctions, eventually leading to a desired goal.⁹ In the realm of economic decision-making, the most important consideration is considering short-term financial prospects when deciding whether to take a risk for a long-term financial gain.¹⁰

Prospect Theory

Prospect theory (PT) emerged as an alternative to EUT in 1979. Rather than rationally considering the utility and probability of an outcome, PT posits that actors make decisions from a personal reference point and fear losses more than gains, even when each outcome has the same probability of occurring.¹¹

There are six major tenets to PT:

1. Individuals think in terms of gains and losses of a decision from a reference point rather than the net outcome.
2. Actors think about gains and losses differently. Decision-makers are less likely to take risks for potential gains and more likely to take risks to prevent loss.
3. Actors dislike losing possessions more than they like winning a similar thing they do not possess (loss aversion). This tendency to over-value possessions is the endowment effect.
4. Since actors make decisions from a reference point, the framing of a problem is crucial. Framing is the interpretation of a situation that a decision-maker uses to respond to events. Framing a situation

in terms of loss makes the situation direr, due to loss aversion.

5. Decision-makers tend to overweight small probabilities and underweight high probabilities.
6. Decision-makers tend to simplify choices, cancelling out options that seem similar.¹²

Generally, PT argues that decision-makers consider options from their own reference point, fear loss, and frame prospective choices in terms of gains or losses. Figure 1 represents the relationship between loss aversion and framing. When actors frame a potential outcome with high probability as a loss, they are more likely to take risks than a high-probability potential outcome in the domain of gains. This is because decision-makers are desperate

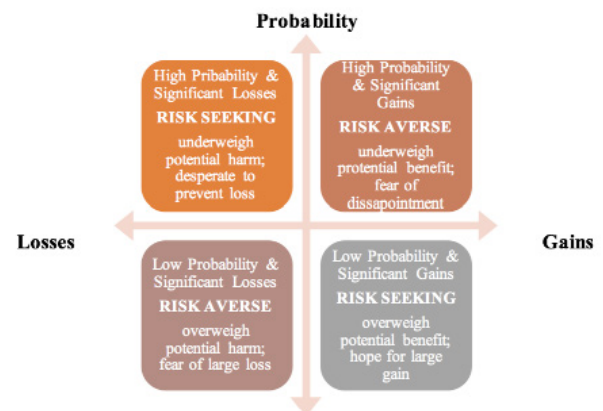


Figure 1

to avoid significant losses. The opposite is true, however, in a low-probability situation.

Analysis

To understand whether either expected utility theory or prospect theory offers a helpful framework for understanding Russian

⁹Hakimdavar, Golnoosh. *A Strategic Understanding of UN Economic Sanctions: International Relations, Law, and Development* (Routledge, New York, 2013): 136.

¹⁰Briggs, Rachel. "Normative Theories of Rational Choice: Expected Utility," in *The Stanford Encyclopedia of Philosophy*, edited by Edward N. Zalta (Stanford University, Stanford, 2015): n.p.

¹¹McDermott, Rose. *Risk Taking in International Politics: Prospect Theory in American Foreign Policy* (University of Michigan

decision-making behavior in relation to the economic sanctions in retaliation to the annexation of Crimea, I apply the major tenants of each theory to key speeches and events. This investigation, while limited by the knowledge available regarding the Russian decision-making process, shows that prospect theory provides the better explanation.

Applied Expected Utility Theory

There are several aspects that one would expect to see while using EUT as a framework to understand Russian foreign policy decision-making in response to the economic sanctions. Among these are the consideration of alternate outcomes with respect to preferences and the probability of each outcome occurring, the perusal of actions in order of favored outcomes, and for Russia to always choose the outcome that will yield the highest utility. Most importantly, EUT expects that Russia will always rationally weigh the probability of success and the utility of a potential outcome before choosing an action.

Does Russia meet these benchmarks? While it is impossible to truly know everything President Putin and his advisors considered when choosing whether to annex Crimea, one can make observations about the utility of Crimea to Russia. Fischer and Rogoza outline the benefits of the annexation: strengthening support for Vladimir Putin, natural gas and crude oil reserves, ownership of the Crimean tourist infrastructure and other industries, and broad access to the Black Sea.¹³ While it is true that the annexation did boost Mr. Putin's approval rating, it is important to note that it was also very high before the annexation. Since 2000,

his approval ratings have fluctuated between 60% and 90%.¹⁴ Putting this in perspective, President Putin's lowest approval ratings are still higher than President Obama's highest approval ratings.¹⁵ He did not need to annex Crimea to save approval rating because it was never in jeopardy. Similarly, Russia does not need Crimea for oil or natural gas reserves. Russia is already the world's second highest producer of fossil fuels, and estimates suggest Russia accounts for more than 80% of the world's energy supply and has a 455-year supply of coal.¹⁶ Russia in no way needs to depend on Crimea for energy resources.

Additionally, the annexation itself spoiled much of the benefit Russia could have received from Crimean industry. Industry in Crimea has suffered, especially tourism, and more than three-quarters of the region's international investments have pulled out of the area.¹⁷ More access to the Black Sea, nonetheless, does still provide Russia with some utility for military infrastructure. However, the vast majority of the identified benefits to acquiring Crimea were not actually very important for Russian interests. Therefore, Crimea has rationally low utility to Russia. Furthermore, Russia's decision to move ahead with the annexation despite warnings from its biggest international trading partners shows that decision-makers did not rationally weigh the costs and benefits of success. Thus, Russian decision-making around the annexation does not reflect the third tenet of EUT.

While planning to reclaim Crimea began three weeks before the referendum during an all-night meeting with security advisors is initially consistent with the second tenet of EUT

¹³Fischer, Ewa and Rogoza, Jadwiga. "A Bottomless Pit: The Costs of Crimea's Annexation by Russia," *Center for Eastern Studies* (2014), n.p., accessed November 18, 2015.

¹⁴Adomanis, Mark. "Vladimir Putin's Approval Rating is Still Holding Steady," *Forbes* (2013), n.p., accessed November 18, 2015.

¹⁵"Barack Obama's Yearly Job Approval Averages," *Gallup* (2014), n.p., accessed November 18, 2015.

¹⁶Clemente, Jude. "How Much Energy Does Russia Have Anyways?," *Forbes* (2015), n.p., accessed November 18, 2015.

¹⁷Yablokova, Alina "Crimea in painful transition one year after referendum," *Global Risk Insights* (March 29, 2015), n.p., accessed November 10, 2015.

giving Mr. Putin and his advisors the benefit of the doubt that they strategically considered their plan), failing to adapt from the point that the international community warned Russia forward fails to reflect this axiom.¹⁸ President Putin failed to consider the potential negative effects of the economic sanctions before continuing with the plan to bring Crimea back into Russia. This is not consistent with the second axiom of EUT because it increases the cost of Russia's first preference (annexation) and Russia failed to choose an alternative, transitively ranked preference.

However, later actions are more consistent with this second tenet of EUT. While not initially adapting to the threat of economic sanctions, the negotiations on the Ukrainian conflict in Minsk, Belarus in February 2015 does appear to align with the EUT notion that actors will pursue transitively ranked preferences. In exchange for the resumption of economic relations (this does not mean an end to the sanctions, however), Russia agreed to a ceasefire in eastern Ukraine, the withdrawal of weapons, and Ukrainian control of the border by the end of 2015.¹⁹ Such negotiations as the Minsk Agreement appear in accordance with EUT. Russia eventually realized the cost of its actions outweighed the benefits, and therefore Russia decided to enter negotiations to move towards a less desired, but overall more beneficial option. Adapting to the situation appears consistent with the transitively-ranked preferences component of EUT.

However, analysis also indicates that Russia never fully considered the utility of its

actions, the fifth tenet of EUT. Objectively, Crimea provides very little benefit to Russia and comes with a very high price tag. In 2014, Russia spent 125 billion rubles on Crimea. In 2016, the country announced plans to invest 680 billion rubles in Crimea by 2020.²⁰ On top of this expense, Russia faces the damaging effects of the economic sanctions. Russia's GDP fell 3.7% in 2015 and while the country did experience some growth in 2016, it has still not recovered to its pre-sanctions GDP.²¹ Additionally, inflation is rising and the value of the ruble is dropping. Combined with Russia's ban on food imports from the EU and U.S. (in retaliation of the sanctions), has caused a sharp increase in the price of food.²² Failing to consider the costs of annexation and properly weigh the negligible benefits is inconsistent with the fourth and fifth axioms of EUT. President Putin and his advisors did not consider potential outcomes by examining both the utility of the outcome and the probability of success, nor did they select the option with the greatest expected utility.

Generally, an examination of Russian decision-making behavior seems very inconsistent with the central axioms of EUT. Therefore, EUT does not appear to be a good explanation of Russian decision-making behavior regarding sanctions and the annexation of Crimea.

Applied Prospect Theory

Prospect theory, as an alternative to expected utility theory, allows for decision-makers to act outside of strictly rational thought. With respect to Russian decision making vis-à-vis the economic

¹⁸Kondrashov, Andrey. "Crimea: The Way Home – EN Subtitles – Full Documentary," *Vimeo* video, March 25, 2015, accessed November 18, 2015. <https://vimeo.com/123194285>; Neil MacFarquar, "Early Memo Urged Moscow to Annex Crimea, Report Says," *The New York Times*, 2015, n.p.

¹⁹Weaver, Matthew and Luhn, Alec. "Ukraine ceasefire agreed at Belarus talks," *The Guardian*, 2015, n.p., accessed November 18, 2015.

²⁰Makarenko, Olena. "Crimea's economy: When Russia's words and figures don't meet," *Euromaiden Press* (Ukraine), May 17, 2016, n.p., accessed February 21, 2017.

²¹World Bank Group, "Russian Federation," The World Bank, accessed February 22, 2017.

²²Birnbaum, Michael. "A year into a conflict with Russia, are sanctions working?," *The Washington Post* (2015), n.p., accessed November 18, 2015.

sanctions and Crimea, there are several components that one would expect to see when using prospect theory as a framework. First, one would expect Russian *perception* of reality to play a bigger role in decision-making processes than objective, rational thought. The fear of loss would also play a role in explaining Russian actions. This loss aversion would also lead to the over-valuation of “possessions.” Finally, one would also expect to see framing of choices in terms of gains or losses. These concepts, applied to key events and speeches, appear useful in understanding Russian decision-making behavior around the economic sanctions.

The idea of loss has surrounded much of President Putin’s rhetoric regarding the annexation of Crimea. If consistent with PT, this loss aversion would also lead to the over-valuation of possessions. Per Rudy and Venteicher,

States are willing to fight to defend the same territory they would not fight to acquire in the first place. In such cases, states fight to defend their territory because they value it more due primarily to the fact that they own/control the land (as suggested by the endowment effect), and possible losses generates more risk acceptant behavior due to loss aversion.²³

In this case, Crimea is the “overvalued possession” that Russia is willing to accept risk and potential loss to defend. Since Crimea is historically Russian territory, Putin views it as rightfully belonging to the Russian Federation rather than Ukraine.²⁴ This is consistent with Russia’s willingness to spend billions on

the tiny peninsula while also struggling due to economic sanctions.

A Standard and Poor’s estimate claims Russia would have to pour approximately one billion dollars into Crimea annually to bring the living standard up to Russian standards. Furthermore, Crimea needs most of its energy, drinking water, and food imported. In addition to the costs of merely maintaining Crimea, there are also costs associated with integrating it into the Russian Federation. This coupled with a steep decline in Crimea’s tourism industry – the largest sector of the Crimean economy – makes the cost of Crimea substantial.²⁵ Despite this cost, Vladimir Putin maintains his position on Crimea, clearly stating, “I believe we did the right thing and I don’t regret anything.”²⁶ He claims the annexation righted a historical wrong – namely, that Crimea always belonged to Russia rather than Ukraine.²⁷ The massive amount of money and resources Russia is willing to pour into a tiny peninsula in the Black Sea appears rationally disproportional. The endowment effect helps to explain the motivation behind such a risky action. This is particularly evident in President Putin’s justifications for the annexation because Crimea is historically part of Russia. This is also an example of loss aversion because Mr. Putin’s justification for the annexation deals directly with Russia’s historical possession of Crimea. This is consistent with the first and third tenets of PT.

According to PT, the desperation to repossess Crimea makes Russia risk-seeking. The willingness to endure economic hardship to

²³Rudy, Michael A. and Venteicher, Jerome F. “Prospect Theory and Economic Sanctions: Towards a Theory of Economic Coersion,” presented at *Midwest Political Science Association*, Chicago, IL (2006): 11, accessed November 9, 2015.

²⁴Kottasova, Ivana. “Sanctions will cost Russia more than \$100 billion,” *CNN* (2015): n.p., accessed November 18, 2015.

²⁵Fischer and Rogoza, “The costs of Crimea’s annexation,” n.p.

²⁶Neuman, Scott. “Putin: ‘No Regrets’ Over Crimea Annexation,” *NPR* (2015): n.p., accessed November 18, 2015.

²⁷Meyers, Steven Lee and Barry, Ellen. “Putin Reclaims Crimea for Russia and Bitterly Denounces the West,” *The New York Times* (2014): n.p., accessed November 18, 2015.

hold on to Crimea already reflects some risky behavior. Russia not only consistently stands behind the actions that led to the sanctions in the first place, but encourages similar actions in other historically Russian regions. Shortly before the one-year anniversary of the Crimean annexation, President Putin signed an agreement to create a common security space and open boarder with South Ossetia, a breakaway region of Georgia. Critics of this arrangement equate it with a Russian annexation of South Ossetia. Russia also supports the separatists in Donetsk and Luhansk in eastern Ukraine.²⁸ These actions all share similarities with the actions that led to the sanctions in the first place. This demonstrates risk-seeking behavior, which suggests that PT offers a fitting explanation regarding Russia's framing of the situation in terms of potential loss of Crimea. This risk-seeking behavior reflects the second precept of PT.

Additionally, PT would also expect to see framing of choices in terms of gains or losses. This is evident in the Russian framing of the situation to fear the loss of Crimea more than loss from economic sanctions. As discussed above, Putin already frames loss of Crimea is a terrible injustice. The economic consequences of the sanctions, however, do not receive an equally negative framing. On the one-year anniversary of the annexation, marked by a huge celebration in Moscow, Putin acknowledged that the sanctions are "not fatal, but naturally damage our ongoing work."²⁹ He went on to argue that the sanctions are worth any ensuing struggle because of what Russia would lose if it submitted to the coercion of the sanctions. In his speech,

frames this potential loss by saying, "The issue at stake was the sources of our history, our spirituality and our statehood – the things that make us a single people, and a single, united nation."³⁰ Putin's statement reflects an awareness of the harmful effects of the sanctions. However, by referring to Russia's "ongoing work," he also alludes to the notion that Russia is not willing to change its policy to bring an end to the sanctions. Putin therefore frames loss from economic sanctions as second to the potential loss of Crimea. Thus, the possession of Crimea is Russia's point of reference and Russia fears losing Crimea a second time in this instance. This is consistent with the fourth tenet of PT.

On the other hand, Russia also faces potential harm from the international community's sanctions. Since Russia fears losing Crimea, they risk economic harm from these sanctions. This harm manifested in several ways since the implementation of the sanctions, including a credit rating cut from Standard & Poor's, a steep devaluation of the ruble, inflation, a decline in foreign investment, falling bond prices, a reduction in economic growth, and a rise in geopolitical tensions.³¹ The desperation to prevent the loss of Crimea, combined with the high-probability of loss due to the economic sanctions and international pressure places Russia in the upper left quadrant of the graph in Figure 1. Forgoing objective and rational thought through the evident overvaluation of Crimea and the underweighting of potential harm from the sanctions is consistent with the fifth rule of PT. Prospect Theory's framework for

²⁸Herszenhorn, David M. "A Year After Seizing Crimea, Putin Celebrates as Ukraine Seethes," *The New York Times* (March 18, 2015): n.p., accessed November 18, 2015.

²⁹"Crimea annexation: Putin admits sanctions 'damaging,'" *BBC News* (2015): n.p., accessed November 18, 2015.

³¹Herszenhorn, "A Year After Seizing Crimea," n.p.

³¹Philips, Matt. "S&P says Russia's Crimea caper has already hurt the economy," *Quartz* (2014): n.p., accessed November 18, 2015.

decision-making appears to offer a useful explanation for understanding Russian decision-making behavior in this case. Loss aversion and the endowment effect describe why Russia so adamantly seeks to keep and support a territory that offers it such little benefit in return, even in the face of risking high financial loss. Moreover, it also offers an explanation for Russian risk-seeking behavior in similar situations since the implementation of the sanctions.

Towards a Better Understanding

In this case, PT offers a more useful understanding of Russian decision-making behavior than EUT. With respect to the sanctions meant to coerce Russia into changing its behavior toward Crimea, rational decision-making does not appear evident, as Russia celebrates the annexation of a region with no noteworthy benefits, despite significant negative financial effects of the sanctions. However, President Putin's rhetoric shows that he does not frame the situation in terms of logical net gains, but rather in terms of the potential loss of Crimea – a Russian “possession.” Russia is willing to risk the financial harm of the sanctions because it fears losing Crimea. This is more consistent with the framework PT offers for understanding decision-making behavior than that of EUT.

Conclusion

Prospect Theory offers the clearest explanation for understanding Russian foreign policy decision-making behavior vis-à-vis the economic sanctions and the annexation of Crimea. This contributes to a comprehension of how states respond to sanctions. In the case of economic sanctions on Russia, PT explains how Russia is willing to accept high financial costs to prevent the loss of Crimea. However, it is also important to note the limitations of this study. As the sanctions are relatively new, it is difficult to fully assess their complete effects at this point in time.

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