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The Illegal Economy Under Gorbachev: Growth and Implications

An Intelligence Assessment

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The Illegal Economy Under Gorbachev: Growth and Implications

An Intelligence Assessment

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The Illegal Economy Under Gorbachev: Growth and Implications

Key Judgments

*Information available
as of 15 March 1990
was used in this report.*

The Soviet "shadow" economy—which includes illegal production of goods and services, under-the-counter sales, and black-market trade—has grown rapidly under Gorbachev. Much of this growth has resulted from the Soviet leader's own efforts to reform society and improve economic performance. The 1985-88 antialcohol campaign, for example, led directly to a sharp increase in illegal alcohol production and diverted revenues from the state sector to producers and distributors operating outside the law. Government revenues stagnated, while budget expenditures increased steadily, resulting in a large budget deficit. This deficit pumped money into the economy that was unmatched by increases in the legal availability of consumer goods and services, creating hothouse conditions for the growth of black-market activities. Laws permitting more private initiative provided additional opportunities for the shadow economy's growth.

The shadow economy has probably served as something of a safety valve enabling better-off consumers to acquire badly needed goods and services, but it has also exacerbated social tensions, reduced the state's ability to meet pressing consumer needs, and offered incentives for increasingly serious and violent crime. Real and perceived connections between the shadow economy and cooperative enterprises have contributed to a popular backlash against all entrepreneurs in the cooperative sector. Resulting restrictive legislation will make it harder for cooperatives to contribute to a solution of the economy's problems. The regime's plan to stem the growth of the shadow economy through better law enforcement is likely to yield minimal results, as long as the incentives to commit such crimes remain strong.

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The Illegal Economy Under Gorbachev: Growth and Implications ²

The "Shadow" Economy Before Gorbachev

When Gorbachev came to power in 1985, the state-controlled system for producing and distributing goods and services and the "shadow" economy—a diverse collection of private economic activities forbidden under Soviet law—had coexisted uneasily for some time. The inefficient state production and distribution system provided fertile ground for the growth of such activities as black-market trading, "underground" production, and under-the-counter sales. Artificially low state prices encouraged black-market trading, while the poor quality of state-supplied goods and services ensured high demand and high prices for better quality goods and services supplied by private entrepreneurs. Stealing from the state was widely viewed as an easy and victimless crime, and the regime's inattention to monitoring personal incomes—which are not subject to large direct taxes—made it easy to conceal earnings derived from unsanctioned economic activity.

The supplementary goods and services delivered by the shadow economy to the population partially compensated for the failings of the state distribution system. In addition, illegal operators responding directly to consumer demand could often use resources more effectively than could state enterprises, which responded to central plans and largely ignored consumer preferences. At the same time, however, the shadow economy reduced the quality and quantity of state production through the diversion of state materials, machinery, and labor to the private economy.

Impact of Gorbachev's Policies

Despite Gorbachev's early emphasis on law and order and his efforts to eliminate the inefficiency that allowed illegal economic activity to flourish, we believe his policies contributed to the shadow economy's growth. Gorbachev's antialcohol campaign of 1985, for example, spurred rapid growth in the illegal production and distribution of spirits by sharply reducing the availability of alcohol in state stores. As

consumers turned to illegal moonshine and homebrew, the state's sizable tax and sales revenue declined and the shadow economy reaped enormous profits. According to economist Abel Aganbegyan, before it was abandoned in 1988, the antialcohol campaign cost the state economy 57 billion rubles in three years, a loss that contributed greatly to the growth of the state budget deficit.

Efforts To Harness Private Initiative. Gorbachev sought to harness and legalize the shadow economy's beneficial aspects with new laws on cooperatives and individual labor. In particular, legislation enacted in 1987 and 1988 substantially expanded the scope of private economic activity and loosened the eligibility requirement for participation. Moscow hoped that increased legal private production of goods and services would boost the consumer sector, preempt illegal operators, and provide the state with a revenue source that otherwise would have gone untapped. Despite a rapid rise in the number of legal cooperatives, however, this legislation failed to stem the growth of the shadow economy. According to Soviet press reports, many illegal operators chose to remain "in the shadows" to avoid taxes and harassment by the authorities, many activities remained unsanctioned, and the growth of the private sector created new opportunities for criminal activity.

"Boom" in the Shadow Economy. Severe problems in the Soviet consumer sector in 1988 and 1989 created even more favorable conditions for the growth of illegal economic activity. Rapid growth in money incomes unmatched by increases in the availability of consumer goods or official increases in prices resulted in an extreme imbalance between demand and supply. In response to these changing circumstances, illegal operators diverted more and more goods away from the state retail trade system via under-the-counter sales, bribery, and theft, and prices on the black market soared.

Black-market trade in consumer goods has come to play an increasingly important role in both wholesale and retail sales. According to [] large-scale diversion of consumer goods from wholesale distribution centers is now occurring in Moscow and other cities. Trucks arrive at local warehouses at night and leave filled with merchandise destined for black-market sale. At a Kremlin conference in October 1989, Premier Ryzhkov called retail trade "one of the most crime-ridden sectors of the national economy" (see figure 1). After a followup conference on the subject in February 1990, Supreme Soviet First Deputy Chairman A. I. Lukyanov stated that the situation in the retail trade sphere had worsened considerably since October

Moreover, according to Soviet experts, there are huge losses associated with the diversion of goods from the formal to the shadow economy. According to one economist writing in the Soviet press, "Operators often deliberately destroy products to steal with impunity . . . arson of warehouses, supply centers, and shops did . . . 47.8 million rubles' worth of damage in 1988. Enormous amounts of meat, vegetables, fruit, and other farm products, thousands and even tens of thousands of head of livestock are destroyed every year." The traditionally high rates reported for damage during transport and storage help to mask the diversion of production to the black market

Laws giving enterprises and cooperatives greater freedom to establish independent foreign economic ties have also provided new avenues for the shadow economy. The Soviet press has reported instances of groups illegally exporting stolen goods, art objects, state-subsidized goods, military hardware, and raw materials abroad for hard currency. Operators then often buy up VCRs and other high-demand Western goods to sell at inflated prices on the Soviet black market. The most publicized example of such a deal was an abortive effort by a cooperative to export shipments of copper and nickel, as well as 12 tanks misappropriated from the Ministry of Defense

The development of joint ventures and increased opportunities for Soviets to travel abroad have increased the flow of hard currency to the shadow

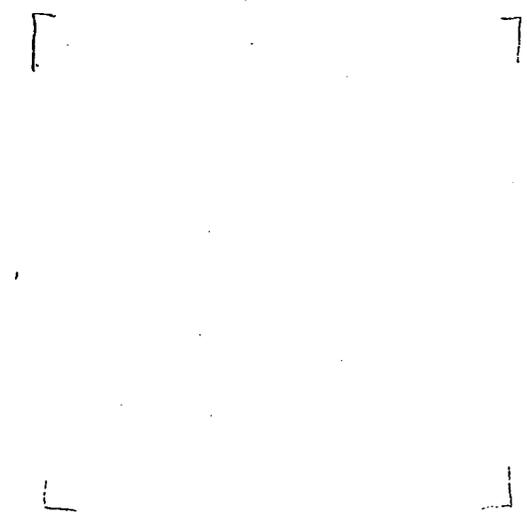


Figure 1. Food leaves the meat and fish store via a back door labeled "No Admittance."

economy. At a January 1990 seminar of the USSR Academy of Sciences, a prominent Soviet economist estimated that there were about 400 million US dollars in the black market. On the other hand, the shadow economy can also be a threat to joint-venture operations [] a German-Soviet joint venture—a hard currency store servicing foreigners in Moscow—was recently closed down because up to 50 percent of its incoming supplies were pilfered by the Soviet staff who took goods home or sold them on the side

Operators in the shadow economy are reportedly becoming increasingly organized and sophisticated. At a December 1989 press briefing, Minister of Internal Affairs Bakatin reported the discovery of "dangerous organized groups of profiteers dealing in sizable shipments of foodstuffs and industrial consumer goods" in a number of regions of the country

According to the Minister, a rising Soviet "mafia" based in the shadow economy is engaged not only in traditional shadow economy activities but also in more serious and violent crime. He reports, for example, that six organized crime groups recently uncovered in Moscow had divided the city into spheres of influence in which they controlled cooperatives, foreign currency speculators, and prostitutes, and engaged in crooked car sales, robberies, extortion, and apartment burglaries

Crime and Cooperatives. The shortcomings of the 1988 Law on Cooperatives have forced legally registered private businesses to make frequent forays back into the shadows to keep themselves afloat. The failure of the law to provide adequate legal sources of supply for private businesses, for example, has forced cooperatives to resort to the shadow economy to obtain materials—which have usually been stolen from the formal economy. To operate without local government harassment, moreover, cooperative workers must often bribe officials. In either instance, stepping outside the law makes the cooperatives more vulnerable to extortion at the hands of racketeers. According to a Soviet press comment, "There are two courses open to a cooperative—either to abide by law and thus be immune to blackmail, or to deliver. . . . More often than not, the first option is out of the question; a law-abiding cooperative won't stay in business for too long." Even when cooperatives do not break the law, they are tempting targets for shake-downs by organized crime. The head of a group of Moscow cooperative workers calculated that bribes and protection money cost the city's cooperatives 31 million rubles last year (see figure 2)

Weak Law Enforcement. The Soviets have been unable to curb what they regard as an "economic crimewave" with the existing law enforcement apparatus. Increasing street crime and a breakdown of law and order have diverted the attention of the militia away from the shadow economy, allowing illegal operators freer rein. According to official statistics, overall crime increased 32 percent last year, but "mercenary" crimes—many of which are related to the shadow economy—increased 60 to 75 percent. The criminal investigation apparatus is ill-prepared to cope with the surging crime rate. Moreover, the



Figure 2. Diagram of a cooperative's expenditures

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militia itself is often corrupt, and many of its members are reportedly paid off by operators in the shadow economy. As a result, officials in the justice system admit that there has been a sharp decline in bringing perpetrators of economic crime to justice.

Impact of the Growth in the Shadow Economy

There has been much debate in the Soviet press over the size of the shadow economy. Both Soviet and Western experts agree that it is difficult to measure accurately, and estimates of its size vary greatly (see inset). State Planning Committee (Gosplan) economist Tatyana Koryagina, who has published the most scholarly Soviet studies of the shadow economy, believes that many recent unofficial estimates are inflated for political reasons—the growth of the shadow economy has become a cause for party traditionalists. Koryagina estimates that the value of goods and services produced or distributed by the shadow economy now amounts to 70-90 billion rubles (Soviet GNP is about 875 billion rubles). By her estimate, about 30 million Soviet citizens—as compared with a state labor force of 130 million—are involved in the shadow economy. Many of these individuals have full-time jobs in the state sector and engage in illegal economic activities either after hours or during work. According to official Soviet statistics published for the first time this year, in 1989 the illegal income of citizens reached—at a minimum—60 billion rubles, including 23 billion from the illegal production and sale of alcohol; 15 billion from under-the-counter dealings by workers in trade, public dining, and health and personal services; and 10 billion from the resale of stolen construction materials, automobiles, spare parts, and gasoline.

Whatever the shadow economy's value, it is undeniably large, and the surge generated by the current crisis in the consumer sector has alarmed Soviet leaders. According to Bakatin, the shadow economy is the most dangerous criminal threat to Soviet society. Its growth is threatening to the Gorbachev regime in several important respects.

Increased Income Inequalities. The shadow economy increases income inequalities and limits the state's ability to maintain the living standard of lower income groups. While Soviet price policy has attempted

Debating the Size of the Shadow Economy

In the last 18 months the Soviet press has published a wide range of unofficial estimates of the value of the shadow economy. As the issue of economic crime has been taken up as a cause by traditionalists, these estimates have ballooned. Among the figures published by Soviet newspapers:

- *August 1988—estimates of 70-90 billion rubles appear in Trud.*
- *Spring 1989—estimates of 100-150 billion are published in Moscow News.*
- *Summer 1989—Argumenty i fakty publishes estimates of 300-350 billion for the "budget" of the shadow economy.*
- *December 1989—Sotsialisticheskaya industriya prints a figure of 500 billion.*

Generally, the Soviet authors fail to describe their methodology or define what is included in the shadow economy. An article by Soviet economists S. Golovnin and A. Shokhin published in the journal Kommunist in January finds most of these estimates overblown and finds fault with all of the approaches currently used to calculate the value of the shadow economy. Golovnin and Shokhin decline to offer their own estimate, noting that careful scholarly analysis of the shadow economy is needed before a realistic assessment can be attempted.

In estimating the value of activities in the private "second" economy in the Soviet Union, Western experts generally do not attempt to separate illegal and legal private activities because of methodological difficulties. Evidence relating to the semilegal and illegal economies is almost entirely anecdotal and impressionistic, and thus cannot be aggregated to provide a reliable estimate of the shadow economy.

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to keep essential goods within the reach of everyone, the large-scale diversion of these goods into the black market has left state stores bare and priced the poorer stratum of society—particularly elderly pensioners—out of the market. At the same time, those who can obtain goods in short supply, often by bribery or theft, are in a position to earn profits many times larger than the average state wage. The large amount of purchasing power in the hands of many Soviet consumers exacerbates the situation. According to Gorbachev, " 'Volatile' money with nothing to spend it on has provided the basis for a substantial redistribution of income by unlawful methods—bribery, speculation, and racketeering."

Increased Political Tensions. At a time of worsening political tensions, the growth of the shadow economy is another source of public discontent. Illegal operators have grown bolder, and their high profits are now much more visible to the public. A letter from a state worker published in *Pravda* last summer, for example, described how a young woman set up shop on the street and sold cases of state-made butter for several times the state price. The writer expressed outrage at the new "brazenness" of speculators. "These dealers used to operate somewhat circumspectly," she complained, "and they dealt in small lots. But here you had whole cases. Her self-confidence made me indignant."

Glasnost has led to regular reports of crime in the Soviet press, and this has also increased public awareness of the shadow economy. As life has become harder for the average worker and the earnings of profiteers has become more visible, traditional public acceptance of the shadow economy has increasingly turned to resentment. The authorities' inability to control the problem has caused such resentment to take on a political coloration. According to Leningrad's new party leader, Boris Gidasov, the highly visible corruption of the second economy is giving rise to "distrust, malice, and aggression" on the part of the public.

Backlash Against Cooperatives. Not surprisingly, the more visible cooperatives, rather than illegal operators, have borne the brunt of public bitterness. State workers have been particularly vociferous in their complaints against the cooperative movement, often

viewing it as an extension of the shadow economy. In 1989, for example, the All-Union Central Council of Trade Unions (AUCCTU) took a sharp stance against "middleman" cooperatives, charging that these businesses simply buy up or steal cheap state goods and resell them at an enormous profit. The trade union lobbied for a ban on these activities. Opposition to newly visible "millionaires" has become a rallying point for recently formed traditionalist workers' groups, including the Leningrad United Workers' Front. One worker writes, "People see how the bigwigs of the shadow economy and the pseudo-cooperatives are getting rich . . . the simple person is more and more frequently asking the question: why are there more and more difficulties for those who are working honestly at state enterprises?"

In part, as a result of public outcry against speculation, in October 1989 the Supreme Soviet approved amendments to the Law on Cooperatives that banned "middleman" cooperatives—those that purchase and then resell goods—and encouraged local governments to set price limits on basic necessities sold by the cooperatives. The decree called for more stringent tax inspections and other efforts to ensure cooperatives make full payment of taxes. In response to complaints that illegal money is being laundered through cooperatives, Gosplan has submitted proposals to the Council of Ministers to enable Moscow to monitor cooperatives' cash and noncash transactions. Cooperatives would be prevented from putting revenues in private accounts, and cash withdrawals would be restricted to funds to pay wages, cover travel expenses, and buy raw materials.

Moscow Searches for a Solution

In the short term, Moscow is approaching the shadow economy as a problem for law enforcement organizations to solve. Tougher measures against the shadow economy are being planned as part of a broader effort to combat rising crime. A draft program that would greatly increase resources for law enforcement, for example, has been prepared and forwarded for consideration by the Council of Ministers. According to the Soviet press, a draft law sharply increasing fines and

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jail terms for abuses in trade and speculation has also been put forward, and special units to combat economic crime have been set up within law enforcement organizations.

On 1 November 1989 Moscow introduced a second special exchange rate for the ruble in an effort to stem growth of the hard currency black market. The rate, which is for noncommercial transactions only, offers tourists 6.26 rubles to the dollar—substantially better than the official rate of 60 to 65 kopecks per dollar. To date, however, the special ruble exchange rate has had little success in encouraging tourists to exchange their rubles solely through official channels because black-market dealers have been willing to pay up to 20 rubles per dollar to counter the government's efforts to drive them out of business.

Most Soviet leaders recognize that, in the long term, stabilization of the consumer sector will be necessary before any real progress can be made in reducing the size of the shadow economy. Moscow has launched an all-out effort to achieve this goal. The economic stabilization program calls for a sharp 10- to 12-percent annual increase in the production of consumer goods and services over the next two years, to be supplemented by stepped-up imports of consumer goods. To meet these targets, Moscow is diverting defense resources and investment in heavy industry to consumer areas. This program, as many Soviet leaders now admit, is almost certain to come up short because it fails to substantially eliminate or neutralize sources of excess demand and because the long-neglected consumer industries lack the capacity and needed inputs to meet plan targets. Additional stabilization measures are now being debated.

One measure under debate is a monetary reform designed to cut excess purchasing power and confiscate the wealth of the shadow economy. The reform is supported by such traditionalists as Ligachev, the United Workers' Front, and the AUCCTU. According to Ligachev, each Soviet citizen could exchange 10,000 to 15,000 rubles for new currency on a one-to-one basis. Individuals with more than that amount would have to document their income or exchange it at a ratio of 10:1. Other Soviet leaders oppose such a reform, however, believing that it would be at best a

temporary solution because the budget deficit—and the printing of money not backed up by goods—persists. Moreover such a reform would probably not do great damage to operators in the shadow economy. According to Ryzhkov, "Shady dealers who are worth their salt will be able to hide their capital, put it in real estate, valuables, and other 'shelters' for dishonestly acquired money."

Outlook and Implications

Koryagina forecasts that the annual value of the shadow economy could rise nearly 45 percent in the next few years, reaching 100-130 billion rubles. More serious crime associated with the shadow economy will probably also increase. Bakatin offered this gloomy prediction at the beginning of November:

Crime probably will have to rise. In the past everyone received 120 rubles a month, but now there are people who earn 10,000, 15,000, or even 90,000. Naturally, there are people who would like to get that much money themselves. . . . In a transitional period there can be no balanced developments, and unbalanced developments always lead to a rise in crime.

We believe the measures taken by Moscow thus far to stem illegal private economic activity will have little impact because they attack only the symptoms of the problem and do nothing to reduce the high incentives to operate in the shadow economy. Low state retail prices and excess purchasing power in the hands of consumers will combine to increase such activities as speculation, under-the-counter sales, and misappropriation of government property. Moreover, to avoid entanglement with the criminal world, the private sector needs reliable legal sources of supply. These will be difficult to provide, however, because enterprises have been given such high targets for consumer goods production they will have few resources to spare. The most effective way to curb profiteering is to improve supplies and to decontrol state prices. Until this is done the incentive to engage in such activities will be strong and enforcement of laws costly. As Koryagina argues, each new step back from

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reform—such as the ban on middleman cooperatives—pushes more economic activity underground and into the hands of the mafia.

Recently passed economic stabilization measures, in our view, increase the incentive to steal from the state and sell stolen goods at a profit. Moscow has also enacted temporary legislation to freeze or more strictly control prices on a number of essential food and nonfood consumer goods. This will likely increase the gap between low state prices and prices that would balance supply and demand, increasing profits for black marketeers. Because enterprises will have less of an incentive to produce goods whose prices are now controlled, shortages may be exacerbated, further driving up black-market prices. Moreover, the problem of decriminalizing the private sector will be complicated by the many corrupt officials who have an interest in maintaining the current flow of bribe money and other illegal perquisites. Bakatin recently expressed cynicism over Moscow's prospects for solving this dilemma, stating, "We do not have an ethic of private enterprise, rather there are the morals of the swindlers of the shadow economy."

The expansion of the shadow economy will complicate Moscow's efforts to improve the lot of the average consumer. Emergency measures to protect consumers from inflation will have a limited effect if state stores are largely empty and illegal channels of distribution are the only alternative. There has been much discussion by Soviet economists of the need to create a market basket of inexpensive goods to be made available through special channels to lower income groups, particularly pensioners—but large-scale diversion of goods to the black market will make this a difficult task.

Fears about the emergence of a class of wealthy and sophisticated criminals may also slow economic reform. Soviet leaders have used the specter of the shadow economy as an argument in favor of slowing additional reforms—particularly allowing private ownership. They fear that loosening central control will allow the vigorous criminal element to step in and take over large segments of the economy.

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