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**CIA HISTORICAL REVIEW PROGRAM
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**Gorbachev: Steering the USSR
Into the 1990s**

An Intelligence Assessment

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July 1987

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**Gorbachev: Steering the USSR
Into the 1990s**

Preface

This paper is intended as a perspective on the kinds of decisions on economic policy that General Secretary Mikhail Gorbachev must make over the next few years and the implications of these decisions for the USSR's defense and foreign policy and for Gorbachev's political position. In this context, judgments regarding Gorbachev's situation will appear somewhat less sanguine than those found in earlier CIA papers, for two principal reasons. First, the papers reporting on Gorbachev's progress through the winter of 1986/87 focused primarily on his success in consolidating his power rather than the concrete and difficult choices he would face in exercising his power. Second, since the plenum of the Central Committee in January 1987, an accumulation of evidence from Soviet sources suggests that indifference and opposition on the part of party and government leaders and the average worker are more deeply rooted than was thought six months ago. Nonetheless, as this June's plenum of the Central Committee suggests, Gorbachev seems determined to overcome these constraints. Gorbachev's road, however, will be rough, and he has warned that the next few years will be critical for his program.

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Gorbachev: Steering the USSR Into the 1990s

Key Judgments

*Information available
as of 30 June 1987
was used in this report.*

In the next year, Soviet leader Mikhail Gorbachev and his Politburo will have to agree on adjustments to the current (1986-90) five-year plan to cope with emerging shortfalls and to correct imbalances. Meanwhile, the future of economic reform is being worked out, and the Soviet leaders will be attempting to formulate their resource allocation guidelines for the 1991-95 plan. The USSR's planning cycle calls for these guidelines to be given to the economic planners by about mid-1988. This will be a tough call because not all the returns will be in from measures already implemented.

Adjusting the 1986-90 Plan

The present five-year plan has virtually no slack that would permit more attention to one of the major sectors of the economy without some impact or offsetting adjustments in other areas. For example, the growth in overall volume of investment, while higher than in the two previous five-year plans, still appears low in comparison with the production targets. Taken at face value, the plan indicates that the Soviets expect a sharply increasing ratio of output per ruble of investment. But if the efficiency gains from the "human factor" campaign do not materialize, the leadership will have to decide whether to push for faster investment growth in the present plan to keep its industrial modernization program on track. Such a step could force the USSR to consider permitting a buildup of debt to the West to finance more imports. And sustained higher rates of investment would not be feasible in our view, without holding military procurement relatively flat.

Similarly, allocations to the consumer in the current five-year plan, particularly goals for consumer durables, have been held down against a promise of better things to come in the 1990s as the hoped-for benefits of industrial modernization are realized. The leadership, however, will have to be careful to avoid the kinds of shortages that in the past have had a dampening effect on labor incentives—particularly because so much of the present plan appears to bank on increasing productivity through a motivated work force.

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Reforms

In the case of reforms, what has been accomplished so far amounts to a set of partial measures. Soviet leaders will need to consider adjustments to those measures already implemented and how to implement the more comprehensive changes in the organization and management of the economy that Gorbachev called for at the Central Committee plenum in June 1987. It will be particularly important for the leadership to avoid the kind of backsliding that has brought past reforms to a standstill. Gorbachev has been searching for a formula that encourages more initiative at lower levels while permitting control to be maintained from the center. This is a delicate balance at best; early in the 1965 and 1979 reforms, for example, the ministries began to reassert their control over enterprises by multiplying the number of plan targets and limiting their use of discretionary funds. And the natural inclination of local party officials will be to exercise the same kind of petty tutelage over enterprises that they have in the past. Preventing this will require a fundamental restatement of the responsibilities of ministries and party organizations.

According to guidelines approved by the Central Committee on 26 June 1987, the next phase in improving organization and management will involve curbing the powers of central economic authorities, developing genuine wholesale trade, reforming the price system and financial and credit institutions, and introducing stronger incentives for enterprises to use their increased independence in ways that satisfy the guidelines set out in the state plan. Gorbachev could also expand the permissible boundaries of private production and allow greater wage differentiation. Even with the best leadership intentions, improving worker incentives will depend mainly on whether workable arrangements in these areas can be developed and on how the labor force reacts to them. Elastic work rules and narrow wage differentials have become an important part of the "social contract" in the Soviet Union.

Formulating Resource Guidelines for 1991-95

The leadership's perception of progress on the industrial modernization program—especially in the machine-building sector—will be a critical factor in its outlook on the next five-year plan. If by next year this program does not appear to promise growth large enough to give generous increments to consumers and defense as well as investment, the leadership will

be forced to decide whether civilian machine building should get more funding in the 1991-95 plan. Another factor that could contribute to pressures for higher investment than originally envisaged for 1991-95 would be a dwindling of the impetus to growth from tightening labor discipline and weeding out poor managers. And a key unknown may be whether the construction and machine-building base will be adequate in scale and quality to support a large increase in investment without a cutback in the defense plan submitted by the General Staff.

Foreign Help

So far, Gorbachev has had little success in obtaining help for his economy from abroad—either from Eastern Europe or the West. The Soviets have had trouble getting their East European allies to shoulder more of the burden of the USSR's resource development and the Warsaw Pact's force modernization. Meanwhile, although the extent to which the leadership planned on increasing imports from the West during the 1986-90 plan period remains an unsettled question, Moscow's ability to buy more Western machinery or farm products has eroded badly because of the decline in world energy prices and the lower value of the dollar. At this juncture, the Soviets appear to be counting heavily on joint ventures with Western firms. They are currently negotiating with about 100 Western companies, although only a few of these negotiations appear to be in their final stages.

The Potential Pitfalls . . .

A wide range of special interests and sensitivities will impinge on Politburo decisions over the next few years. First of all, military support for the modernization of civilian industry could erode substantially if the external threat assessment now being offered by military leaders becomes starker because arms negotiations fail to constrain NATO defense programs and bilateral US-Soviet relations worsen. In the reform arena:

- A relaxation in the tautness of the economy would help innovation and ease a transition to new economic arrangements, but Gorbachev stands in the way. From his first days in power he has stepped up the pressure on workers, managers, and bureaucrats.

- Ministries are not likely to easily accept a lesser role in administering the economy. They probably will try to entrap their enterprises in a new web of rules and requirements, while ideological conservatives will fight an expansion of private economic activity.
- Genuine elections for party-state offices would evoke the specter of factionalism and be seen as a threat to the top-down direction of the society and the economy that has characterized "democratic centralism" for 60 years.

... And A Helpful Environment

The investment/defense decisions to be made would, of course, be generally much easier if economic growth turned upward sufficiently to ease the resource bind and diminish some of the fears of the fence sitters in Gorbachev's Politburo. At the same time, arms control agreements and improved US-Soviet relations that reduced both the momentum of NATO military programs and the influence of the Soviet military-industrial complex would give Gorbachev more room to maneuver. Soviet success in these areas would in turn raise Western interest in granting credits to Eastern Europe and establishing joint ventures in both the USSR and Eastern Europe.

Somewhat paradoxically, however, better economic performance and a favorable international climate would both strengthen and weaken the case for more ambitious economic reform. Reform is easier to implement when annual GNP growth is high, but the urgency attached to a reform program tends to fade when the economy is doing relatively well.

Gorbachev's Next Steps

At considerable risk to his political future, Gorbachev is gambling that his policies will rejuvenate the USSR's economy and society. The problems he is encountering have not yet derailed his program or diminished his determination to change the system radically. But even his supporters are concerned that he will need to win new victories before long if he is to sustain the momentum for change he has generated.

Thus, we believe that Gorbachev cannot work out the next steps toward renewal at his leisure. Developments during the past year have increased the chances that he will act boldly to sustain the momentum of his program. Because he seems determined to protect a modernization program that is already underfunded and because the milestones for fashioning the 1991-95 economic plan are fast approaching, Gorbachev is likely to seek arms control agreements in the final years of the Reagan administration rather than wait for the next election. Moreover, the weaknesses of the reform measures undertaken thus far are likely to become clearer over the next few years. We think Gorbachev is likely to move forward rather than retreat and push through more radical reforms so that they will be in place for the 1991-95 plan period. In this context, Gorbachev sees publicity and elections at lower levels as a way of exposing and disciplining those who will not or cannot implement his program. In the economy, workers probably will have a greater say in choosing trade union officials, foremen, and even managers.

The Consequences of Failure

Gorbachev has already asked the military and the population to curb their appetites in return for more later. If his programs do not work out, other leaders could appeal to these constituencies. The risks in a more radical reform and a rewrite of the social contract are that confusion, economic disruption, and worker discontent will give potential opponents a platform on which to stand. Gorbachev's position could also be undermined by the loosening of censorship over the written and spoken word and the promotion of limited democracy. If it suspects that this process is getting out of control, the party could well execute an abrupt about-face, discarding Gorbachev along the way.

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Gorbachev: Steering the USSR Into the 1990s (

Introduction

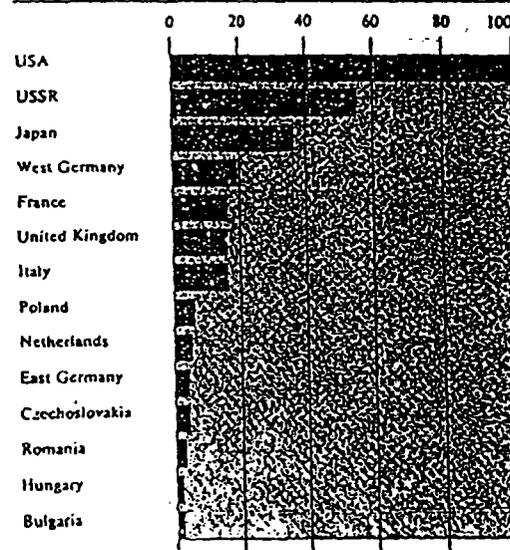
Mikhail Gorbachev was named General Secretary of the Communist Party of the Soviet Union in part because an aging Soviet leadership recognized that something had to be done to lift the USSR out of the economic growth slowdown and the political stagnation that characterized much of the last half of Brezhnev's rule and the brief Andropov-Chernenko stewardship. The "correlation of forces" had been shifting against the Soviet Union:

- Growth of Soviet GNP dropped from an average of 4.0 percent per year in the period 1966-75 to 2.3 percent in 1976-80, and to 2.2 percent per year in 1981-84.
- Although these rates were roughly comparable to those prevailing in the West, the level of Soviet GNP was little more than half that of the United States. In per capita terms the USSR's position among major industrialized countries was even worse (see figures 1 and 2). Continued Soviet growth in the 2- to 3-percent range would prevent the USSR from closing the GNP gap and might cause it to widen.
- Soviet leaders became increasingly concerned over the USSR's (and CEMA's) technological position as microelectronics-based technology transformed manufacturing processes and weapons design in the West.
- Unrest in Poland, economic stagnation and even recession in much of Eastern Europe, and "counter-revolution" in Afghanistan, Angola, and Ethiopia imperiled the stability of the Soviet empire and increased the cost of maintaining it.
- China's domestic reforms and its dealings with the United States worried Moscow.

Figure 1
Gross National Product, 1985

Index: USA = 100

■ Western countries
■ Eastern countries

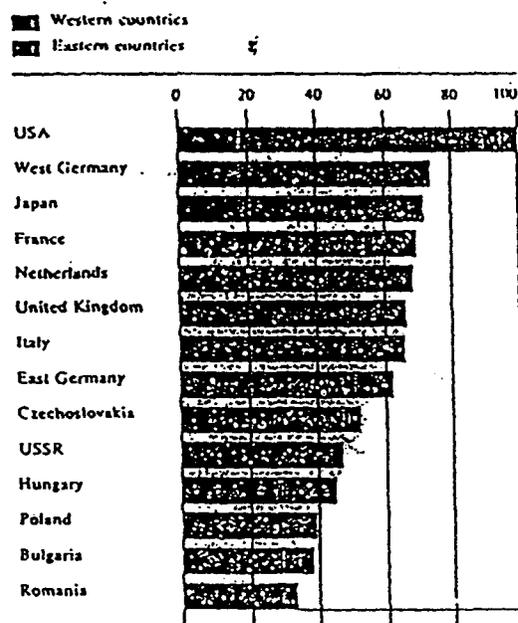


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- Even the military gains accumulated in the 1970s were threatened by the Carter-Reagan defense buildup and NATO's modernization of its conventional and theater nuclear forces.

Figure 2
Per Capita GNP, 1985

Index: USA = 100



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This congruence of adverse trends appears to have convinced a divided Politburo, even though it was still dominated numerically by holdovers from the Brezhnev years, to pick a younger, more aggressive man to be General Secretary. Nonetheless, the Gorbachev Politburo—at least in its first months—probably was united more by a sense that new policies were needed than by agreement on what the policies should be.

In a recent assessment,⁴ the CIA described in general terms the progress Mikhail Gorbachev has made in his program for *perestroika* (renewal). The assessment discussed the combination of controversial policy directions and bureaucratic resistance that “will force increasingly clear choices between settling for half measures . . . or forcing the Politburo to make some difficult decisions.” This assessment extends and amplifies our initial benchmark report on Gorbachev’s policies and position. It outlines his economic strategy and options in greater detail, discusses the military and military-economic considerations that limit his freedom of action, and reviews the role that foreign policy developments can play in helping or hindering his program. In particular, the assessment focuses on Gorbachev’s near-term agenda—the decisions that will have to be made during the next few years and the factors influencing these decisions.

Setting a Course

Investment Strategy

Gorbachev has reversed the course of investment policy set out in the last half of Brezhnev’s administration. The five-year plans during the late 1970s and early 1980s had called for low rates of growth of new fixed investment to facilitate (read “force”) “intensive” (productivity-based) economic growth. This “low investment” strategy appears, in fact, to have been as much a rationalization as it was an economic strategy. An alternative course featuring higher investment allocation at a time when economic growth was slipping. Characteristically, the Brezhnev Politburo sidestepped these choices, hoping that all of the links in the economy would “do better” and provide the planned growth in consumption and defense with smaller increments in investment. But merely stressing innovation and the reequipment of existing factories failed to offset the drag on productivity caused

⁴ DI Intelligence Assessment, February 1987, *Gorbachev’s Domestic Challenge: The Looming Problems*, (U)

by an immense aging stock of plant and equipment and underinvestment in key sectors like metals and machine building. The dismal results of the low-investment strategy encouraged the development of a "high investment" lobby—one member of which (Nikolay Ryzhkov) is now Gorbachev's Chairman of the Council of Ministers, and another (Abel Agabegyan) one of his principal economic advisers.

The basic idea behind the new investment strategy is to renew the Soviet stock of plant and equipment by a combination of high rates of investment and increased rates of retirement of old plant and equipment. Because the existing stock of fixed capital is so large, however, its renewal will take time. Soviet planners, therefore, do not count on a large, immediate impact on economic growth in the midterm—perhaps three to eight years.

Encouraging Sustained Growth in Productivity

Gorbachev and his spokesmen have repeatedly asserted that, although higher investment growth rates represent the quantitative dimension of the modernization program, the qualitative dimension is decidedly more important. By this they mean that the returns on investment depend heavily on the technological level of the new plant and equipment being installed and the efficiency with which it is used. In the first instance, the leadership is relying on what might be called "administered technical progress"—stricter quality controls, more internal review of new product designs, and more thorough screening of proposed investment projects.

Another avenue toward accelerated technical progress is the attempt to stimulate the introduction of new technology and the production of better products through incentives that lead enterprises and R&D institutes to be more creative. To shape the organization and administration of the economy (or in Soviet parlance, the "economic mechanism"), Gorbachev is searching for a combination of organizational changes and economic levers that will encourage this kind of initiative at lower levels, while permitting control to be maintained from the center. Other Soviet leaders have said this was their goal but either could not find the formula (Khrushchev) or rejected it upon seeing its implications for the role of the party in the economy

(Brezhnev). Indeed, toward the end of its rule, the principal preoccupation of the Brezhnev leadership was to hold on to power—an objective for which any major shakeups of the system would have been seen as threatening.

Gorbachev, however, has called for "radical reform" (by Soviet standards) and seems disposed to go beyond the tinkering with the system that satisfied his predecessors. But a great deal of uncertainty surrounds his ultimate economic reform objectives. Indeed, Gorbachev admits that his reform program is being worked out "on the march."

The other part of Gorbachev's long-term program for accelerating productivity stresses incentives to work harder and more effectively. He has picked up on a recurring theme in Soviet economic debate—that worker pay should be tied more directly to contributions to production. As a result, wider income differentials are likely to be a feature of the economic mechanism that is developed under Gorbachev's leadership. Soviet leaders recognize, however, that the incentive effect of higher incomes will be degraded considerably if they cannot be used to buy goods and services that the population wants. The leadership's declared strategy is to have investment grow more rapidly in the 1986-90 plan period, setting the stage for consumption growth to outstrip investment growth in the 1990s.

Progress So Far Under Gorbachev

Reform Measures

Gorbachev's call for a radical reform of Soviet economic management at the party congress in March 1986 marked the first time such a dramatic remedy had been prescribed by any Soviet official in recent years. In the months since the congress, he has further escalated his rhetoric, comparing the reform to a "revolution" and describing it as a major turning point in Soviet history. His strong commitment to reform also is reflected in a changed political

environment that has turned economists whose ideas were once considered outside the mainstream into establishment figures.²

Reorganizing the Bureaucracy. A cornerstone of Gorbachev's reform effort has been his attempt to reorganize and streamline the central economic bureaucracy. His insistence that this bureaucracy shift its focus from day-to-day management to strategic planning and coordination has been reflected in a number of organizational changes. Central coordinating bodies—in the form of bureaus, state committees, and commissions—have been established to oversee ministries responsible for the agro-industrial sector, civilian machine building, energy, construction, "social development," and foreign trade. Two new organizations—the State Committee for Computer Technology and Information Science, and the Ministry of Atomic Energy—also have been established to perform work that previously had been scattered among several agencies.

These moves all seem aimed at improving Moscow's ability to coordinate activities in a given economic sector, but they also have created another management layer and have generally done little to meet Gorbachev's stated goal of paring the size of the economic bureaucracy. Moreover, the agro-industrial reorganization, which did eliminate a number of ministries and some positions, proved to be highly disruptive. Hopes for reducing the size of the bureaucracy now appear to rest on a conversion to the "two-tier" management structure advocated by Gorbachev, which eliminates the all-union industrial associations—the bureaucratic layer between the ministries' higher management and the production enterprises.

Increasing Enterprise Autonomy. Gorbachev has asserted repeatedly that better economic performance requires a combination of stronger and less detailed central planning and more autonomy for the enterprise. Enterprises are to be financially independent and to make a greater share of decisions regarding production and investment. Thus far, the main reform under way in this area is one begun under Andropov and extended by Gorbachev on 1 January 1987 to all of industry and some other sectors (see inset)

The Experiment in Enterprise Autonomy

The Soviet experiment in industrial management launched under Yuriy Andropov in January 1984 is designed to increase productivity, promote innovation, and improve product quality by increasing the enterprise manager's incentive and ability to pursue these goals. Specifically, the experiment:

- Reduces the number of enterprise performance indicators and makes the satisfaction of customers' demands for new and better products—as reflected in delivery contracts—the major measure of enterprise success.
- Increases the rewards for fulfilling plan targets and the penalties for failing to do so.
- Gives the enterprise manager greater control over investment funds and material rewards for his work force.

Konstantin Chernenko paid lipservice to the experiment and extended it to additional branches of industry. Mikhail Gorbachev put additional teeth in its provisions for improving product quality and modernizing capital equipment and ordered that the experiment go into effect industrywide in January 1987

In his effort to increase the authority and responsibility of industrial enterprises, Gorbachev's most significant achievement may turn out to be a new law, approved at a June 1987 session of the Supreme Soviet. This law codifies the enterprises' rights and gives them legal protection from bureaucratic meddling. Other measures that have been introduced are more limited in their coverage. They give selected enterprises the right to:

- Deal more directly with their suppliers, rather than funneling their requirements through authorities in Moscow.

- Trade directly with foreign firms.
- Base their production plans on trade orders from customers.
- Exercise greater financial autonomy and retain a larger percentage of their profits.

Although these measures represent a significant step toward increased enterprise autonomy, many of them apply to only a small number of enterprises or contain other restrictions that limit their impact:

- The decree allowing enterprises to acquire their supplies through "wholesale trade" applies primarily to enterprises of "nonproduction" ministries, like the Ministry of Culture, and excludes most of those in the industrial sector, where the supply problems Gorbachev has complained about have been most acute.
- Although 70 enterprises have been given the right to engage directly in foreign trade, that right is limited to "above-plan" production, and the enterprises can keep part of the resulting revenues only if the Foreign Trade Bank approves of their intended use of the funds.
- The decree allowing enterprises to base their production plans on orders from their customers applies only to clothing, textiles, and shoes and is weakened by its failure to allow enterprises to choose their own suppliers and by the continued priority assigned to centrally set targets.
- Only a limited number of enterprises will switch this year to the kind of "complete financial autonomy" practiced experimentally by plants in Sumy and Tol'yatti, and that autonomy will not include any price-setting authority. Many firms do not earn enough profits to be self-supporting.

The objectives and limitations of these and other reform initiatives in both the farm and nonfarm sectors are considered in somewhat greater detail in table 1.²

Decentralizing Agricultural Authority. As part of his effort to decentralize authority in the agricultural sector, Gorbachev told the 27th Party Congress in

February 1986 that collective and state farms should be given greater control over the sale of their above-plan production. He conveyed the impression that a major reform on this issue was in the works by calling it a contemporary version of Lenin's "tax in kind"—a historic measure that put an end to the state's confiscation of all farm surpluses and established stable, relatively low procurement targets.

When the decree was published in March 1986, its chief decentralizing effort was to allow local officials to set their own targets for produce intended for "local supply" and to exchange food products with other regions, instead of channeling their requests through Moscow. Farms were also given the right to sell an increased percentage of their planned production at collective farm markets and through consumer co-operatives. The tax-in-kind symbolism was completely absent from the language of the decree, however, and there were no indications that the targets for state procurements would be substantially lowered or that prices would be effective guides to decisionmaking—necessary steps for any major decentralization of production controls.

Most important, there was no followthrough on Gorbachev's stated intention to provide an environment that relates reward to effort. This requires a pattern of incentives (and penalties) to induce farm managers and enterprises providing goods and services to farms to carry out their functions effectively and promptly.

The Economy

As the new economic program was being put into place, Soviet economic performance was better but not brilliant (see figure 3).³ In Gorbachev's first year, the outcome was respectable after a bad start in the first quarter. Improved weather, after a severe winter,

² The recent record is spelled out in some detail in *Gorbachev's Modernization Program: A Status Report*, an unclassified paper presented by the Central Intelligence Agency and the Defense Intelligence Agency for submission to the Subcommittee on National Security Economics of the Joint Economic Committee, Congress of the United States, 19 March 1987.

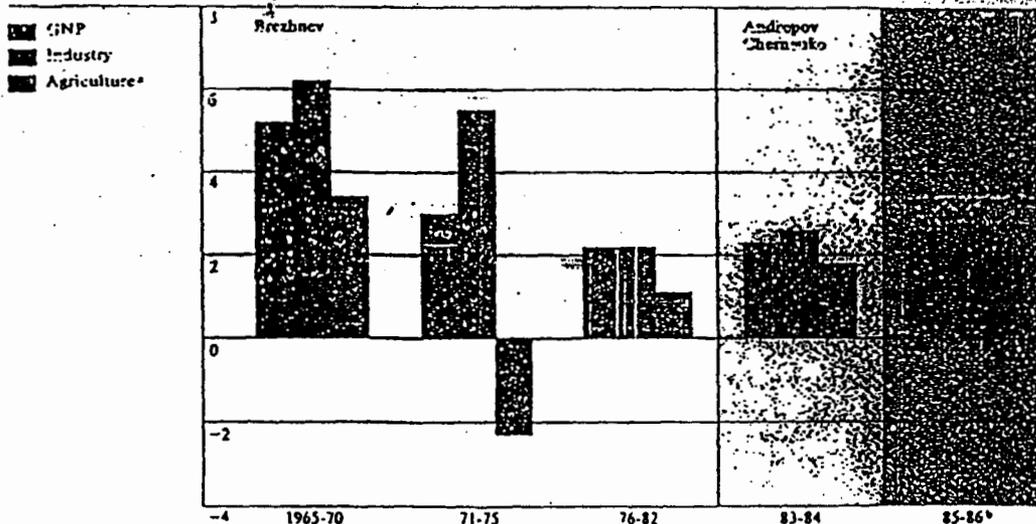
Table 1
Gorbachev's Reform Initiatives*

Category	Objective	Limitations
Enterprise autonomy	To allow enterprises to make more day-to-day decisions with less interference from the ministries.	Enterprises still receive a fairly detailed set of production targets. Their decisionmaking is further "guided" by performance indicators, assigned supplies, controls on investment, wage norms, and administered prices.
Wholesale trade	To reduce central controls over the distribution of enterprise supplies and to expand the use of contracts between enterprises.	There is no specific timetable for the shift to wholesale trade and no guarantee that the reforms will eventually allow enterprises to choose their suppliers freely. For the present, enterprises will only be able to influence marginally the quality of the goods they receive.
Self-financing	To allow enterprises to keep a larger share of their profits, which can be used for operating expenses and investment.	Enterprises will have difficulty obtaining investment supplies because of the centralized supply system. Many firms do not earn enough profits to be self-supporting. There is no provision for the redistribution of capital funds to more "efficient" enterprises.
Bankruptcy	To allow the liquidation of enterprises that operate at a loss.	The current price system is designed to enable the average enterprise to earn a profit. Given an administered price system and success indicators not necessarily reflecting efficiency, the basis for making judgments about liquidation is uncertain.
Wages	To create pay differentials and a closer relationship between workers' pay and the amount and quality of work they produce.	Pay increases will depend upon enterprises' ability to finance them from funds related to productivity increases. Wage "normatives" will be set by superior organs.
Agriculture	To increase self-financing, give farms greater control over the disposal of their product, and encourage the workers' interest in final harvest results.	These goals continue to conflict with the irrational price system for farm products and industrial inputs, high procurement targets, and centralized allocation of material resources.
Private activity	To increase incentives for individual, family, and small group businesses.	These are cautious regulations—much more restrictive than those enacted in Eastern Europe. Participation is limited, for example, to housewives, students, pensioners, and state employees working in their free time.
Foreign trade	To allow a limited number of enterprises to conduct trade directly with foreign partners and promote joint ventures with Western firms.	Central control remains tight over most foreign trade, and firms participating in joint ventures are insulated from the rest of the economy.

* See forthcoming SOVA Research Paper, *Economic Reform Under Gorbachev: A Set of Progress Indicators*.

USSR: Economic Performance Under Gorbachev and His Predecessors

Average annual growth rates (percent)



* Excludes farm products used within agriculture and purchases by agriculture from other sectors.
 * Preliminary.

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eased pressures throughout the economy. This minirecovery continued in 1986. Soviet GNP increased by 4.2 percent, industrial production climbed by 3.6 percent (the fastest growth since the mid-1970s), and agriculture rebounded with a 7.3-percent gain, largely on the strength of large increments in the grain and potato crops.

Almost all of the improved performance, however, can be traced to actions taken by Gorbachev's predecessors. Brezhnev and then Andropov relaxed the five-year plan constraints on new fixed investment imposed by the "intensive growth" philosophy, removing some of the bottlenecks that had plagued the economy in 1979-82. Andropov initiated the campaign to enforce tighter discipline in the workplace that also

contributed to higher industrial growth after 1982, and Brezhnev's farm program seems to be having an increasing impact, especially on the scale of fertilizer applications and the balance in livestock rations.

Gorbachev's contribution to better economic performance consists of his pumping up the discipline campaign, which had flagged somewhat under Chernenko, his initiation of an antialcohol campaign, and his shakeup of the ministerial bureaucracy. The fruits of his reform initiatives and his investment policy will not be evident for a few more years. Nonetheless, as

General Secretary for the last two years, Gorbachev can and is taking credit for a start on the *uskoreniye* (acceleration) that he has set out as a national objective. [REDACTED]

In his public appearances toward the end of 1986 and at the January 1987 Central Committee plenum, however, Gorbachev stressed that not all the economic signs were positive. He noted in particular that little progress had been achieved in raising the quality of industrial products, especially machinery. Throughout 1986, in fact, the machine-building complex was admonished for its failure to meet goals for product quality, output mix, and delivery schedules, and, in April 1987, a *Pravda* editorial declared that it was "absolutely intolerable" that so little progress had been made in improving quality and accelerating technical progress. [REDACTED]

The difficulties in improving quality standards from above are illustrated by the operation of an ambitious quality control system introduced in some sectors of industry on 1 January 1987. The new system, known as State Acceptance:

- Covers 1,500 industrial enterprises that we estimate are responsible for roughly 15 percent of all industrial output and nearly one-third of the production of the critical machine-building sector.
- Augments existing plant quality-control forces with an independent staff of state-appointed inspectors who have the final authority over matters of quality at the plant.
- Is similar to, and may have been modeled after, the program used by the military for many years to ensure the quality of defense goods. [REDACTED]

State Acceptance has already jolted industry. According to the Soviet press, the new inspectors rejected approximately 10 to 20 percent of the products submitted. These items, according to Soviet law, were excluded from monthly production figures. As a result:

- Many plant directors and workers did not receive their usual bonus payments for meeting the plan, which reduced their monthly income by as much as one-third.

- Industrial performance dropped markedly. With machinery production 5 percent below levels for 1986, largely as a result of State Acceptance, we estimate that civilian industrial output during the first quarter of 1987 grew by barely 1 percent in comparison with first-quarter 1986. [REDACTED]

Moscow presumably hopes that the disruption caused by the program's initial shock will prove temporary and that the imposition of higher standards will over time improve the quality of economic growth. Indeed, circumstantial evidence suggests that Gorbachev may have intended State Acceptance as an administrative measure to discipline industry in a manner similar to the antialcohol campaign. Over the long haul, however, the new system is only the first step in an uphill battle against poor quality. Even if successfully applied throughout industry—a risky step, given the considerable disruption even a limited introduction has caused—the new system can only ensure that products meet some acceptable level of quality. As currently designed, State Acceptance cannot tackle the issue of advancing technology to Western levels. [REDACTED]

To spur technological advance, the USSR has adopted measures to strengthen the R&D establishment and especially its ties to industry. There is a new emphasis on Academy of Sciences' support for the machine-building sector, and 20 interbranch scientific-technical complexes, each headed by a lead agency, have been set up to tackle scientific problems of national importance. For the longer term, investment projects are being given stricter technical review to ensure that they incorporate the best available technology. Meanwhile, the 1986-90 plan sets extremely high goals for the production of computers, new machine tools, robotics, and other advanced equipment. [REDACTED]

The Consumer

The leadership's policy toward the Soviet consumer has been to look for ways of improving his lot that do not cost a great deal. The Consumer Goods and Services Program adopted in October 1985 sets out

impressive goals for the year 2000, but the sectors turning out these goods and services—except for housing—cannot look forward to substantial increases in investment allocations in the 1986-90 plan period. Instead, Gorbachev is trying to deal with particular problem areas by other measures. New laws extending the boundaries of private activity and permitting the formation of producer cooperatives are intended to increase the supply of services by drawing in additional labor to the service sector and encouraging the recycling of scrap products. At the same time, machine-building enterprises are being ordered to set up service centers to repair the appliances that they manufacture, and all enterprises have been given targets for providing other services.

Nonetheless, Gorbachev does not have much to brag about regarding consumer well-being in the last two years. Whether in independent Western estimates or in Soviet calculations, per capita consumption has grown slowly (table 2). The authorities have been unable to provide enough other goods and services to offset the huge decline in legal sales of alcohol—which weighs heavily in family budgets in general and the food component in particular.

How the Soviet population views Gorbachev's contribution to its welfare is unclear. In the public mind, he is probably perceived as an activist trying to get the country moving again and as the person responsible for the antialcohol campaign and an increasingly demanding work environment. Attacks on government bureaucrats and party big shots are likely to be popular, but, according to some Soviet sources, Gorbachev's preaching about a new attitude toward work is finding an increasingly sour reception.

Adjustments to the Reform Package

In general, the changes that Gorbachev and reform-minded economists have been advocating would:

- Streamline the central bureaucracy and shift its focus from day-to-day management to strategic planning and coordination.
- Increase the authority and responsibility of industrial and agricultural enterprises.
- Improve workers' incentives.
- Increase the flexibility of prices.
- Expand the role of personal initiative in both state and private sectors.

Table 2
USSR: Growth in Per
Capital Consumption
and Real Income

*Average annual
percentage growth*

	1981-82	1983-84	1985-86
Per capita consumption (CIA estimate)	0.1	1.4	0.2
Food	-0.8	1.0	-2.9
Food, excluding alcoholic beverages	0.0	1.6	2.3
Nonfood	0.7	2.0	3.3
Services	1.3	1.5	2.0
Real income per capita (Soviet calculation)	1.7	2.5	2.4*

* There is a growing suspicion among Western analysts that the Central Statistical Administration manipulated the accounting of real incomes (as well as retail trade and national income) for the period 1985-86 to exclude or minimize the effects on reported performance of reduced alcohol production and consumption and higher prices for alcohol.

Taken together, the management reforms initiated since the party congress in March 1986 are intended to give Soviet policy a decided push in these directions. One standard against which to judge the proposed reforms is how far they shift decisionmaking power down the hierarchy of the economic mechanism that links central authorities, ministries, associations, state enterprises, and households. So far, the higher level authorities still dominate, with most of the decisions governing economic activity still centralized as in traditional centrally planned economies.

Adjusting to Reforms Under Way

What has been accomplished so far can be described as a set of partial reforms (see inset). The first set of decisions facing Soviet leaders will involve the adjustments necessary to extract the most benefit from these partial reforms. Among the adjustments that should be made are:

- A price revision to once again bring prices more in line with costs. This is needed to provide a better basis for the decentralized decisions permitted under the extension of the industrial experiment; the most recent revision was in 1982-83.

Partial Versus Comprehensive Reforms

The following tabulation compares the partial economic reforms the Soviets have undertaken with what would constitute comprehensive reforms:

<i>Partial Reforms</i>	<i>Comprehensive Reforms</i>
<i>Administrative decentralization</i>	<i>Economic decentralization</i>
<i>Phased introduction of reform measures and selective experiments</i>	<i>Simultaneous introduction</i>
<i>Parameters (norms) changed frequently (for example, taxes and subsidies)</i>	<i>Parameters to be left unchanged for years</i>
<i>Detail of plan targets reduced</i>	<i>Abolition of obligatory enterprise targets</i>
<i>Limited freedom given to enterprises to negotiate contracts</i>	<i>Enterprises choose their own suppliers</i>
<i>Managers given more control over wage fund and decentralized investment</i>	<i>Removal of most controls over wages and investment</i>
<i>Sales and profits given more importance as performance indicators</i>	<i>Profit is sole performance indicator</i>
<i>Some producers given right to engage in foreign trade</i>	<i>Direct participation by firms in foreign trade</i>
<i>Wholesale prices revised to reflect costs more closely, but not to balance supply and demand</i>	<i>Price system changed to better reflect both costs and supply and demand and to be more flexible through decontrol of centrally fixed prices</i>
<i>Private activity encouraged on household agricultural plots and in service sector</i>	<i>Wide-scale use of family in agriculture</i>

Unclassified

- Actions by the state supply network to make available the goods required to support (a) investment that is no longer included under the centralized state plan and (b) private production of goods and services [REDACTED]

It will be equally important that the Politburo resist the backsliding that has brought past reforms to a standstill. Early in the 1965 and 1979 reforms, for example, the ministries began to expand their control over enterprises by multiplying the number of plan targets and limiting enterprise use of supposedly discretionary funds. In these earlier instances, the

State Planning Committee (Gosplan) and the ministries quickly decided that decentralized investment was aggravating the already troublesome excess demand for investment goods and was being used in ways that did not suit them [REDACTED]

The Politburo will also have to resolve the question of the proper role of the party. Given the importance that the General Secretary has attached to accelerating economic growth and raising the quality of production, the natural inclination of local party officials

will be to exercise the same petty tutelage over enterprises that they have in the past. To prevent this will require a fundamental restatement of the responsibilities of ministries and party organizations. [REDACTED]

In part, Gorbachev's challenge with respect to the party resembles that inherent in his investment strategy. He can renew the party ranks just as he can the country's capital stock. The trick is to substitute new, more effective members for the aging leaders that have retired or have been dismissed from party service. At the same time, however, the Soviet leadership must come to grips with the question of how to square an activist—and hence, centralized—party role with an economic mechanism that grants greater decision-making power to the individual enterprise. [REDACTED]

Complementary Decisions on Labor Incentives
Soviet leaders appear to agree that labor incentives have weakened with the narrowing of wage differentials over the past two decades, the slower growth in the labor force, and the failure to match rising incomes with an appropriate mix of goods and services. They hope that the modernization program will free some labor and that the Food Program adopted in 1982 and the campaign to improve the service sector will eventually ease shortages in retail markets. But they have only taken a few steps on the road toward tying earnings more directly to contributions to production. [REDACTED]

Through wage decrees, planners are removing some of the inequities that have developed over the years—for example, abysmally low wages for workers in health, education, and scientific research—and engineers' wages that are less than those of assembly line workers. To differentiate earnings according to productivity is far more difficult in production enterprises, which work under unequal conditions in terms of the quality of their equipment and the evenness of their supplies. In this connection, the effort to convert to a collective contract or brigade contracting system—under which small groups of workers establish their own production plan and decide on how bonuses should be divided—seems to be sputtering. Moreover, increasing income differentials and correcting wage distortions will necessarily be a slow process as long as the USSR holds to what a leading Soviet sociologist

has termed the "accepted principle"—no one's wages can be reduced. Under this constraint, noninflationary growth in income differentials depends on increasing the production/net imports of consumer goods and services. Gorbachev will have to commit a good deal of his energy and authority if a wage system more responsive to differences in individual productivity is to be introduced. [REDACTED]

Possible Extensions of Reform

At the plenum of the Central Committee in June 1987, Gorbachev won approval of "The Main Provisions of the Fundamental Restructuring of Economic Management." A package of measures following up on these guidelines is supposed to be approved by the beginning of 1988. As Gorbachev noted, these changes in planning and management will have to be in place in time to be reflected in the 1991-95 plan—especially any having to do with the way the plan is compiled or requiring a new array of prices. [REDACTED]

Gorbachev seems bent on pushing decentralization in the Soviet Union, and relying more on economic levers and less on administrative assignments. If he sticks to this course, he will have to find ways of attaining two key objectives set out in the June 1987 guidelines—developing a genuine wholesale trade system and introducing stronger incentives for enterprises to use their increased independence in ways that satisfy the guidelines set out in the state plan. [REDACTED]

Wholesale Trade. The principal benefit from developing wholesale trade would be to relieve central authorities of the burden of planning the production and distribution of millions of products. By relying more on contracts negotiated freely and directly between suppliers and customers or on orders given to wholesale bases that in fact offer a choice of products, the production plan could be developed from the ground up. One prominent Soviet economic journalist suggested that three-quarters of the turnover of producer goods could be handled through wholesale trade. This would, however, be a controversial decision. Planners in the USSR generally believe that the way to ensure

balance in the economy is to increase the number of physical output targets. Similar measures have been tried in Eastern Europe and abandoned, primarily because overly taut plans created imbalances that higher authorities felt compelled to address.

Incentives. Some of the most important possible changes suggested in Soviet publications to support decentralized management and improve the incentives structure include:

- Reliance solely on profits as a measure of success and failure.
- Allowing enterprises to be declared insolvent or bankrupt.
- Relieving enterprises of the responsibility of finding employment for redundant workers.
- Converting completely to self-financing for both current and capital outlays.

All of these changes would be controversial because they depart so abruptly from past practice.

The leadership has also sought to increase the supply of consumer services, and thereby enhance work incentives, by loosening the permissible boundaries of private production. Should Gorbachev wish to move further along this path, he could allow full-time members of the labor force to withdraw entirely from state employment. A much less likely option would be to go further and permit owners of private establishments to hire labor. Alternatively, the state might, through administrative discretion or by decree, widen the acceptable range of private activity to include, for example, small-scale manufacturing or subcontracting for state enterprises.

The Climate for More Drastic Reform

Because of the barriers that inertia and latent opposition throw up against economic reforms (see inset on page 13), the leadership's willingness to move forward to carry out the decisions of the plenum in June is likely to be influenced heavily by how well the economy does in 1987-88. Reasonably high annual rates of growth of national income (Soviet style)—say on the order of 3.5 to 4 percent—might tend to blunt the incentive for reform.¹ Continued shortages of energy, raw materials, and semifinished products

¹ This translates into a 2.5- to 3-percent growth in GNP.

would also inhibit a transition to wholesale trade. Gosplan and the Council of Ministers almost certainly would want to recentralize distribution of key commodities to protect the priorities they believe the national interest requires.

Progress in improving worker incentives will depend mainly on whether arrangements that are both effective and administratively workable can be developed and on how the labor force reacts to them. Elastic work rules and narrow wage differentials have become an important part of the "social contract" in the Soviet Union (see inset on page 14). Moreover, some of the notable labor disturbances in the USSR have been touched off by changes in work norms. The authorities, therefore, will carefully monitor the reception accorded to an increase in inequality of earnings. Extensive experimentation probably will be the rule over the next few years.

Perhaps the most favorable environment for an extension of the reform would be disappointing macroeconomic performance in the short run—enabling Gorbachev to argue that the reforms already undertaken were inadequate—coupled with an international situation that permitted a degree of economic slack. Low growth in national income would signal failure on the productivity front and perhaps convince the rest of the leadership that drastic reform was necessary. A less tense international situation would permit slower growth or even reductions in defense programs and could result in a substantial increase in net imports, perhaps through success in pushing joint ventures or greater Soviet borrowing. On both counts, the tautness in the economic plan would be relaxed, providing a better climate for reform. But, if poor performance continued over a period in which reforms were being assimilated, the reform ship would probably sink. To keep it afloat, the leadership would have to be able to point to some positive results from the change in the economic mechanism.

Resistance and Inertia

The resistance to change on the part of the bureaucracy is highlighted in the following extract from an interview given by Yevgeniy Arshartumov of the USSR Academy of Sciences to an Italian newspaperwoman:

Gorbachev is finding it more difficult to carry out his reforms because, especially in the seventies, instances of inertia and distortions accumulated in our society—not only faults on the part of individual leaders but bad habits rooted in several strata of society, not just within the leadership groups. And in 1956 it was not yet a vital necessity to move onto another, intensive, stage of development. At that time, though changing, society retained the same development mechanisms, whereas we now know that we cannot continue living as we did until yesterday—and this is most important. In other words, reform has now become urgent, which is why he is talking about *uskoreniye*, the need to change as quickly as possible. "There is no other way," Gorbachev has said repeatedly, whereas in 1956 history granted us a certain amount of time. First of all, the economy no longer has the reserves it did many years ago and furthermore there is the accumulated resistance of the groups that manage the economy. He and his team are convinced of the need to surmount these obstacles.

Unclassified

Adjustments to the Present Five-Year Plan

Before the end of 1988, Gorbachev and his Politburo will have to reach agreement on adjustments in the 1986-90 plan because the present plan is so strained that substantial continuing modifications are likely to be necessary.

The kind of skepticism encountered on the regional level was captured by the well-known political commentator Fedor Burlatskiy in his fictional account of a "Polemical Dialogue in Restructuring." Streshnev is a deputy oblast executive committee chairman who, in the succession to the chairman's job, leaves out to Shirokov, a friend from party school days.

(Streshnev): Well, I've listened to you carefully, Vasily, and this is what I have to say. Just don't get upset. Nothing will come of all this, nothing!

(Shirokov): Why not?

(Streshnev): There is a simple argument. This is the third time in our lives that we've tackled these questions. The first time was after Stalin's death. Do you remember, we were students then. We spoke of nothing but reforms, democracy, social self-management. What happened? ... The second time was in 1965, when the Central Committee plenum announced the launch of the economic reform. And again nothing. Everything vanished as though it had never existed, as if swallowed by quicksand. But why? That is something to ponder—why?

(Shirokov): What's the conclusion you draw from these examples?

(Streshnev): This is not our way. It contradicts the whole system.

Investment Policy

Although investment is scheduled to grow substantially, the goals embodied in the plan turned out to be far less ambitious than implied by Gorbachev's earlier statements on the need for a rapid renewal of the

The Social Contract

A leading student of the Soviet labor force has described the social contract as follows:

We understand the term "social contract" to mean not a legally enforceable guarantee, but rather a set of mutual expectations by the rulers and the ruled. In return for putting up with the debilities of the political and economic system, the population is provided with the benefits expected from socialism—full employment, individual job security, a relatively egalitarian distribution of income, and steady improvements in material well being. As it has worked out in practice, the contract also has meant acceptance by the populace of a largely hidden system of privileges and perquisites for the political elite and tolerance on the part of the leadership of widespread "second economy" activity by the populace. Overall, the result has been the appearance of low-grade welfare states with relatively low standards of living and low levels of work effort and, hence, of labor productivity. (U)

Gertrude E. Schroeder
"Work Effort, Incentives and the Standard of Living in the Soviet Union and Eastern Europe"

country's capital stock (notably at the July 1985 plenum on science and technology). Much of the planned overall growth in investment was concentrated in 1986. After that, total investment is to rise slowly, while the volume of retirements is to be double that of 1981-85 to speed up the renewal of fixed capital.

This investment plan looks like a mismatch when compared with the 1986-90 targets for output. Indeed, the plan implies a sharp reduction in the USSR's incremental capital-output ratio (ICOR) for branches of "material" production—the increase in productive fixed capital required per ruble of growth in Soviet-style national income (see table 3). The ICOR implied for 1986-90 is much lower than any

Table 3
USSR: Incremental Capital-Output Ratios, Past and Planned
Billion rubles

	Increase in Material Production ^a	Increase in Productive Fixed Capital ^b	ICOR
1971-75	67	274	4.1
1976-80	57	354	6.1
1981-85	57	420	7.3
Plan 1986-90	135	471	3.5

^a Essentially, GNP less the labor component of services to the population and government in 1982 prices. The increases in both production and fixed capital represent values in year *t* minus values in year *(t-5)*.

^b 1973 estimate prices. Productive fixed capital represents total fixed capital less that found in the so-called nonproductive sphere—housing, health, education, and the like.

ratio since the 1960s. Because the increase in the number of people working in material production will be insignificant, the Soviet Union has to be counting on a combination of large improvements in the quality of fixed capital and the efficiency with which it is used. This may well be the 1986-90 plan's fatal flaw because, we believe, the collection of actions taken to improve the quality of investment or management will not have a large impact during this period.

If efficiency gains sufficient to turn the Soviet ICOR around do not materialize, Gorbachev will have to decide whether to push for faster growth in investment during the present five-year plan to keep his modernization program from stalling. This would, however, raise potentially divisive issues. For example, the USSR might then have to allow a buildup in its debt to the West to import more Western equipment, particularly if world energy prices have not recovered by then. More important, we believe sustained high rates of investment growth are not feasible without holding down procurement of military hardware.

Consumer Policy

As noted earlier, the consumer was slighted in the original version of the current five-year plan. The leadership will have to watch carefully to see that the flow of consumer goods and services is sufficient to avoid a return to the shortage-plagued situation of the early 1980s and a consequent dampening of labor productivity. The authorities have already raised the goals for housing construction and consumer durables in the 1987 plan above those included in the five-year plan. Further concessions in the form of above-plan investment in agriculture, services, and the soft goods and food industries may be required—not to prevent unrest but to elicit the kind of motivated work that is a key element of renewal.

The Politburo has one weapon that can be used at any time to ameliorate shortages and reduce queuing—selected retail price increases. Gorbachev has said—most recently, at the June plenum—that the past policy of rigid retail prices except on luxury goods and alcohol should not be sacrosanct. Articles have also appeared in the Soviet press explaining why very low rents for state-owned housing subsidize most those who are best able to pay. But the Soviet worker is accustomed to low fixed prices on food and housing. Indeed, the leadership has not had the nerve to adjust retail prices to reduce excess demand in consumer markets since price increases on meat and butter in 1962 sparked strikes and civil disturbances. Whether the present leadership does so will be a test of how much support it thinks it has among the workers.

Defense Policy

When Gorbachev became General Secretary, the 1986-90 plan was in the last stages of compilation. We know that he remanded the plan repeatedly, seeking more strenuous targets for industrial production, but we do not know what, if anything, he did to the defense plan. In any event, the current five-year plan does not appear to have room to accommodate sizeable growth in military investment (construction and hardware procurement). As noted earlier, the planned volume of new fixed investment is already low relative to the output targets, and allocations of machinery to the consumer sector are lean.

This tightness in the 1986-90 plan does not, however, appear likely to impinge on many, if any, of the military modernization programs planned for the rest of the decade, as long as Moscow does not decide to accelerate them. Soviet outlays for military procurement have increased at an average rate of 1 percent per year since the mid-1970s. But the high level of absolute spending achieved by then from the massive force buildup of the late 1960s and the surge of modernization in the early 1970s has supported the production and deployment of an impressive array of military hardware.

In the late 1970s and early 1980s, moreover, the Soviets invested heavily in their defense industrial base. The plant and equipment needed to produce almost all of the military systems scheduled for delivery in the next five years is already in place, and the systems themselves are already coming off the assembly lines. These final assembly facilities are for the most part not readily convertible directly to civilian production, and the short-term economic gains from sharp cutbacks in any of the major defense programs are small relative to the security concerns and potential political costs each cutback would almost certainly entail. The competing demands for labor, materials, and intermediate products such as electronic components, however, could slow the pace of some weapon programs and at a minimum are likely to constrain any significant acceleration.

Setting Guidelines for Resource Allocation in 1991-95

At the same time that the Soviet leadership is dealing with adjustments to its present five-year plan, it will need to be formulating its resource allocation guidelines for the next (1991-95) five-year plan. To meet the requirements of the planning cycle, these guidelines should be given to the economic planners about the middle of next year. The first major step in the process—formulation of the plan for development of the armed forces—should already be under way.

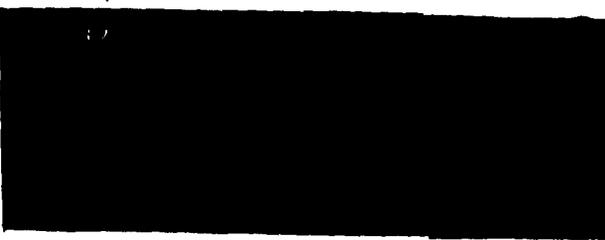
Figure 4
Soviet Five-Year Planning Process



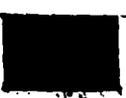
Economic Plan Milestones

-
- 1986 • Gosplan reviews economic performance and assesses long-term economic potential
-
- 1987
-
- 1988 • Gosplan uses models to assess economic growth under different scenarios
-
- 1989 • Central Committee drafts basic guidelines for five-year plan.
• Gosplan drafts control figures for resource allocations, including split between military and civilian sectors.
• Central Committee/Council of Ministers approve control figures.
• Ministries and industries revise plans and transmit them to Gosplan.
-
- 1990 • Gosplan integrates and adjusts industry plans, calculates supply obligations between sectors.
• Ministries and industries mesh production plans with control figures.
• Gosplan calculates detailed delivery schedules and transmits them to ministries and industries.
• Ministry of Defense reviews five-year plan.
• Defense Council reviews five-year plan. Ministries and industries work out further details for supply and delivery schedules.
-
- 1991 • Final leadership approval of five-year plan.

Note: Intervals are approximate and vary somewhat from planning cycle to planning cycle.



Perhaps the most important factor affecting plans for resource allocations in 1991-95 is the perceived progress in industrial modernization during the present five-year plan, especially in the machine-building



sector. Does it promise growth dividends large enough to give generous increments to consumers and defense as well as investment? If not, does civilian machine building require more funding? And will the construction and machine-building base support a large increase in investment without a cutback in the defense plan submitted by the General Staff?

The leadership's effort to set its 1991-95 resource allocation guidelines will be all the more difficult because at the time the guidance is needed—mid-1988 or so—not all of the returns from critical parts of the present five-year plan will be in. For example, in holding down allocations to the consumer sector in the present five-year plan, the leadership is counting on the discipline campaign plus the promise of benefits to come to sustain worker commitment. But, if the impetus to economic growth from enforcing labor discipline and weeding out poor managers dwindles in the next few years, Gorbachev will have to decide whether a policy shift is necessary in favor of an investment growth rate in the 1990s higher than that underlying the plan goals that have been sketched out for the year 2000. This will be a difficult call to make by mid-1988, especially if defense requirements cannot be predicted with reasonable certainty.

The Soviets prepare for weapons production during the roughly 10 years before the initiation of series production. The largest expenditures on these preparations—including those for most of the machinery

and equipment, tooling jigs, and fixtures—are incurred in the last half of this period. This analysis of developmental programs in train suggests that the Soviets would have to invest heavily in the late 1980s and early 1990s to support their production in the next decade. The level and pace of this investment will depend on the leadership's assessment of the external threat in the late 1990s and beyond.

Controlling the Defense Burden

Pressures for Higher Defense Spending. During the past several years there have been signs that the military has been pressing for higher rates of growth in defense spending. We suspect, in fact, that the hints of military concern that have been visible reflect a much larger but so far unarticulated pool of sentiment within the professional military and probably in certain civilian quarters as well. Indeed, Brezhnev's public meeting with the uniformed military in October 1982—which was in effect the party addressing the military—was, we believe, a reflection of some behind-the-scenes controversy over the military's share of the budget. Accompanied by senior civilian leaders, Brezhnev pledged "to tirelessly strengthen the defense of our country." At the same time, he talked of the country's economic problems and the needs of energy, transportation, and agriculture, and he sounded a theme that Gorbachev would pick up later when he said it was "exceptionally important to master already deployed weapons and utilize their full combat potential."

Some of this restiveness probably is a natural consequence of the military's having endured a decade-long stretch of low real growth in spending for the armed forces. A more clearly defined and substantially more influential source of pressure, however, is the concern on the part of many military authorities that over the longer term the military advantages afforded the USSR by its numerical advantage in conventional forces in the Eurasian theaters may be eroded by Western advances in advanced-technology nonnuclear weapons.

In this connection, a sizable body of Soviet military writings since the late 1970s has described the military balance between the United States and the Soviet Union as one of nuclear standoff, and thus one in which the relative capabilities of the two superpowers and their allies to wage conventional warfare has again become a potentially dominant factor. Some of the most authoritative evidence of this view is found in remarks made by former Chief of the General Staff Nikolay Ogarkov in unclassified writings published in the early and mid-1980s.

Marshal Ogarkov and Conventional Weapons

In a book published in 1985 (History Teaches Vigilance), Ogarkov argued that the size and diversity of the nuclear arsenals of the two superpowers had reached the point that neither could deliver a disarming first strike; both sides would have sufficient surviving forces after receiving an attack by the other to deliver a devastating retaliation of such proportions that all-out nuclear war was an unacceptable option. Ogarkov further asserted that, once nuclear war was initiated on any scale, escalation was virtually inevitable. And in view of NATO's avowed intent to employ nuclear weapons if necessary to prevent a military victory by the numerically superior Warsaw Pact conventional forces, Ogarkov conceded that war between the two alliances was likely to become a nuclear conflict. (u)

in his public articles Ogarkov was implicitly urging, we believe, an increase in the resources devoted to defense. Not only must the nuclear stalemate be maintained in the face of reinvigorated Western effort, he

declared, but also a major commitment of technology and industrial resources must be devoted to strengthening and modernizing conventional forces. The resource implications of the line being pressed by Ogarkov may well have seemed overwhelming to a party leadership grappling with a sagging economy and the knowledge that the USSR's aging industrial base was causing it to slip further behind the Western economies. While the evidence is circumstantial, we suspect that Ogarkov's public airing of these views was a major factor in his demotion in September 1984. [REDACTED]



The argument that defense requests should take into consideration the economic situation seems to be having some resonance in the military. Soviet military spokesmen have always recognized the importance of industry's contributions to defense, but until recently they rarely mentioned the economic impact of defense spending. Now, Soviet officers openly discuss the opportunity costs of resources devoted to defense. Deputy Chief of the General Staff Makhmut Garyev, for example, wrote in an unclassified military journal in 1985 that the resources allocated to the military "must be kept within the bounds of strict necessity, so that defense will be reliable and will not be extremely burdensome for the state over time." Another military officer, writing in an unclassified Ministry of Defense publication, acknowledged that,

in the interplay of resource demands for future growth, consumer welfare, and the military, "too much" defense spending is a danger to the state:

It is necessary to bear in mind that, on the one hand, insufficient economic support of the Soviet armed forces can be a threat to national security, while, on the other hand, excessive use of economic resources on defense objectives and unjustifiably large military expenditures inevitably lead to a slowing of economic development. This in turn can reduce the state's military-economic power. [REDACTED]

To stave off criticism that his plans for industrial modernization are cutting into defense programs, Gorbachev has argued that future Soviet ability to compete militarily depends on keeping up with the West technologically. Even under Brezhnev, the rapid evolution of new weapon systems heavily dependent on sophisticated electronics seems to have convinced Soviet military and civil leaders that the traditional incremental approach to weapons development was no longer viable in many areas. The leadership responded to this situation with a sharp increase in investment devoted to the modernization of defense industry in the mid- and late 1970s, notably in the tank and aircraft industries [REDACTED]

To buttress their approach to the military budget, Gorbachev and other Soviet officials have called for "new thinking" in the formulation of national security policy. They have emphasized three themes:

- *The economic dimension of national security.* Soviet leaders have linked an improved economy to the expansion of the USSR's influence abroad, and Gorbachev has contended that the challenge posed by the arms race to his country's superpower status is as much economic as it is military.

- *The limits of military power.* Gorbachev has, in addition, tried to table a concept of "mutual security" that attaches increased weight to political factors. In elaborating on this theme, political commentator Aleksandr Bovin declared that it is necessary in international negotiations to take into account the legitimate interests of one's partner.
- *Stability.* According to some Soviet officials the nuclear balance is now sufficiently stable that, unless the United States deploys nationwide ballistic missile defenses, increases in the US arsenal would not necessarily change it. As early as 1984, Marshal Ogargov maintained that both sides had so many nuclear weapons that a further buildup was senseless.

Public exposition of these themes may be—and in some cases clearly is—intended to influence Western policy. Gorbachev's linkage of "new thinking" on defense to his economic strategy suggests, however, that he is trying not only to affect Western opinion, but also to bring Soviet defense and foreign policies in line with his perception of the USSR's economic capabilities and priorities.

Meanwhile, Gorbachev has gone on the offensive with arms control proposals calculated to erode support for NATO military modernization and to eliminate or constrain the SDI of the United States. It would be difficult if not impossible for him to resist for long the political and military demands for more resources for defense that would result from continuing improvements in US strategic capabilities and in conventional force technologies. SDI, in particular, confronts the Soviets with an extreme form of competition they wish to avoid. US deployment of an SDI system would upset the strategic balance and almost certainly lead to a new surge in spending on strategic systems. A Soviet decision to proceed with a space-based ballistic missile defense system would be enormously expensive. Even a decision to counter US efforts by rapidly expanding Soviet strategic offensive programs (unless accompanied by deep cuts in spending for conventional forces) would probably be expensive enough to force Gorbachev to scale back his modernization goals. Indeed, many of the resources needed to support an SDI system—particularly those involving microelec-

tronics, computers, and telecommunications—have also been singled out by Gorbachev as critical to his modernization program.

In effect, Gorbachev must manage the military competition with the United States politically in order to avoid having to deal with it in ways that could subvert his economic agenda. The eagerness he has shown to reach an INF agreement very likely reflects this strategy. The resource implications of an INF agreement by itself are minimal. But the larger process of arms control is seen by Gorbachev as his principal avenue for politically constraining external pressures for enlarging the USSR's overall resource commitment to the military—at least until he can begin to reap some productivity gains from his industrial modernization efforts. He probably believes that a successful conclusion of a major agreement with the present US administration will provide momentum to the arms control process and create pressure for subsequent movement toward agreements on strategic offensive and defensive forces as the United States moves into an election year.

Enlisting Foreign Help for His Economic Program

To support his economic policies and reduce the near-term strain imposed by the modernization/defense trade-off, Gorbachev is already looking at the assistance that trade with Eastern Europe and the West could provide and at possibilities for limiting the costs of empire.

Eastern Europe

Present Soviet policy toward these countries—as in the past—has focused on getting them to shoulder more of the burden of Soviet economic development and Warsaw Pact force modernization. On both counts, the USSR is having trouble implementing its policy. Soviet plans to extract more and better machinery and consumer goods from Eastern Europe in return for Soviet fuel, raw materials, and machinery have had to be reassessed because of the sharp decline in world energy prices, to which Soviet prices are tied.

Because of the continuing shift in the terms of trade in favor of Eastern Europe, real Soviet imports from the region are not rising as much as hoped, and the price in terms of Soviet exports is going up. We estimate that lower prices may reduce the value of Soviet energy exports to Eastern Europe by as much as 20 billion rubles during the current five-year plan—most of it during 1988-90.

During the 1976-80 and 1981-85 plan periods, Soviet attempts to obtain substantial increases in East European spending on military modernization foundered, largely because of the region's economic difficulties and the skepticism of East European leaders regarding the military threat from NATO.

Moscow is also promoting integrated work in science and technology among CEMA members. In December 1985, CEMA adopted a program calling for stepped-up cooperation in electronics, automation, nuclear power, and new materials. To implement the program, Moscow is pushing hard for the establishment of joint production associations that will develop and produce a variety of products, mostly in high-technology fields. The Soviets are trying to weave a web of research and machine-building cooperation and specialization that could help the USSR's technological progress appreciably. But Moscow will have to keep up the pressure, and the returns will necessarily be deferred for some years.

Western Help

How much the Soviet Union intended to rely on increased imports from the West during the 1986-90 plan period is an unsettled question. Soviet commentary at times has stressed the importance of stepping up trade within the Bloc and avoiding dependence on

the West; at other times the benefits of the international division of labor have been cited in saying that the East-West ties would also expand. Privately, Soviet leaders have admitted the great importance of access to Western technology.

Whatever the leadership's intentions, the USSR's ability to buy more Western machinery or farm products has eroded badly because of the decline in world energy prices. We expect Soviet hard currency earnings in 1986-90 to be 10 to 15 percent less than in 1981-85—when favorable prices for energy and raw materials allowed the Soviets to purchase record quantities of agricultural goods and Western machinery and technology. The decline in Soviet purchasing power with respect to Western goods will be even greater—perhaps about 30 percent—because of the fall in the value of the dollar and the fact that about two-thirds of Soviet exports are priced in dollars. An initial reflection of the deterioration in Soviet terms of trade with hard currency countries was the roughly 15-percent drop in the volume of Soviet imports from the West in 1986.

In another area—preparing the way for joint ventures with Western firms—the Soviets are hoping for better luck. A new law published in January 1987 authorized foreign companies to have a 49-percent equity in Soviet enterprises. Soviets have described their search for joint ventures as a way of introducing the manufacture of products salable on Western markets for hard currency, gaining quicker access to Western technology (and evading some export controls), and learning Western management techniques. They are negotiating with about 100 Western companies, but only a relatively few negotiations are in the final stages. Potential Western partners are being cautious; they want critical questions such as labor-management relations, costs of Soviet labor and raw materials, distribution of investment, and arrangements for repatriating profits spelled out in individual contract negotiations. Nonetheless, if Moscow is willing to make the concessions necessary to make joint ventures attractive to the West, the impact on Soviet industrial performance could be large.

Another source of larger imports could be increased borrowing in the West. The USSR has not picked up this option since it allowed a sharp buildup of debt in the mid-1970s. The debt-related trouble that East European countries encountered, Western sanctions related to Poland and Afghanistan, and a basic reluctance to depend too much on the West for machinery (or even grain) all figure in the more cautious Soviet attitude toward imports and indebtedness [REDACTED]

Cost Avoidance

While seeking support from client states and Western countries, Soviet leaders have talked about reducing foreign aid commitments. Gorbachev [REDACTED]

[REDACTED] told foreign policy officials in 1986 that the USSR's commitments should be reviewed and changed, if necessary, to correspond to what is possible and essential. Foreign Minister Shevardnadze reportedly enlarged on this theme, asking whether the Soviet Union could meet all of the commitments set out in military treaties—for example, in Latin America. In another context, Yegor Ligachev has said that Soviet front organizations and publications centers abroad were of little use and a large drain on Soviet resources. The USSR probably has not settled on a new trade and aid policy toward the LDCs, but the fact that only five countries entered into significant new development aid agreements with Moscow in 1986, as compared with about 10 to 15 per year in 1981-85, may be a straw in the wind. [REDACTED]

Outlook

The Primacy of Domestic Progress

The fortunes of Gorbachev's program for the longer term and his own political position will be determined primarily at home. Prickly questions of resource priorities, changes in the social contract, and even democracy in the workplace, in the party, and in government will be much more easily resolved if the General Secretary's policies are seen to be working. (On the other hand, short-term economic success probably would not—as argued above—encourage drastic economic reform.) Whether this is so depends first of all on whether economic growth is sustained at a higher level. At one level, faster economic growth

would signal that a combination of human factors, redirection of investment, and modest economic reform is reviving Soviet productivity, one of the major objectives of Gorbachev's policies. At another level, the Soviet leadership can best balance the competing interests of institutions, classes, and nationalities through an acceleration of economic growth. For example, Gorbachev said at a plenary meeting of the CPSU Central Committee in January 1987 that "the people will judge our policy and our reorganization effort, and do this the more strictly, the more time goes by, by the palpable results we achieve in securing practical improvements in the working and living conditions of the millions." [REDACTED]

These "practical improvements" in the population's living standards need not reflect much more than an increasing abundance of food (especially meat, fruit, and vegetables), clothing, housing, and more reliable appliances and a greater availability of simple services. For the military establishment, the party, and the policymaking and government elite, the perspective is different. Gorbachev has sold his program to them first on the grounds that it will bring the USSR to the front rank technologically, ensuring the country's military competitiveness and embellishing the reputation of the Soviet socialist model. Second, he has argued that economic reform and socialist democracy are inextricably involved in the modernization process by fostering innovation and raising efficiency. The party, government, and military leaders will want to see whether modernization and reform are, in fact, resulting in better products. Is the technological basis being established for the weapons systems needed in the late 1990s and beyond? Are Soviet manufactured goods competitive in world markets? On the sidelines, some skeptical elements of the party and government bureaucracy stand ready to sabotage economic decentralization, private activity, and participatory decisionmaking at the enterprise level or in government and party affairs. They will be looking for signs of disorder that would justify direct intervention. [REDACTED]

The Potential Pitfalls

Although the issues on the Politburo's agenda have already been discussed, the special interests and sensitivities that will be involved in these decisions are worth singling out. First of all, there are the military and military-economic plans for 1991-95. As noted earlier, the evidence regarding the strength of military support for industrial modernization coupled with constraints in defense programs is ambiguous. In any case, such support could erode substantially if the external threat assessment becomes darker because arms control negotiations fail to constrain NATO defense programs and bilateral US-Soviet relations worsen. Moreover, if any rival wished to challenge Gorbachev, the high ground of national security would probably be a more attractive issue than some of the issues involving institutional interests or differences over what the party should be doing.

Decisions affecting Soviet technological development also promise to create divisions. A seemingly straightforward proposal to buy more machinery and technology from the West would have a variety of opponents. Some highly placed scientists and party officials argue that Soviet science and research and development have been unfairly appraised and that it is dangerous to become dependent on foreign sources for technology. Gorbachev himself, in a visit in May 1987 to the Baykonur space center, declared:

Once again a simple but very important question comes to mind: Why do we at times try to acquire even simple items from abroad if we are today capable of resolving such vast, large-scale and complex tasks? Everything seen here leads once again to the deep conviction: There is no reason for us to go abroad, hat in hand in this way. No embargoes, no ban imposed by certain foreign circles on selling us technology and equipment will slow down the development of our country or the implementation of the great social and economic plans connected with restructuring and the acceleration of our economy.

Other Soviets, especially those who stress the importance of material incentives, are likely—given prevailing hard currency constraints—to highlight the negative trade-offs involved in purchasing more machinery and less grain and food products.

Another trade-off—a relaxation in plan tautness to encourage innovation—would bear even more forcibly on technological progress but also would be even more contentious. Here, Gorbachev himself stands in the way; his actions from his first days in power have been aimed at stepping up the pressure on workers, managers, and bureaucrats. Loading additional assignments onto an economic plan has been the pervasive response of Soviet political leaders. Rather than make choices, they close the gap between program requirements and available resources by raising productivity targets across the board.

Meanwhile, Gorbachev's campaign against inertia and resistance in the government bureaucracy is just beginning. The turnover in personnel has been high, but the issues have not really been joined. To the extent that the economic experiment is implemented and enterprise self-financing becomes general, the roles of ministries and planners will have to be redefined. They will not conform quietly, however; ministries instead are likely to strive to entrap their enterprises in a web of new reporting requirements and procedural rules. Moreover, because the current experiment does not provide sound signals to the enterprises, there will be enough "irrational" decisions to bolster the case of those inclined toward greater centralization in economic administration.

The acceptable bounds for private and cooperative activity will be worked out incrementally over the next few years with the implementation of the decrees issued in 1986. Expanding these boundaries could do a great deal—and at relatively low cost—for a consumer program suffering from lack of support. Nonetheless, Gorbachev could easily evoke bitter opposition by loosening the restrictions on private employment. Ideological conservatives already consider it a retreat from socialism, and—as is the case with the economic experiment—there is so much disequilibrium in price and cost relationships that a high-income entrepreneurial class could spring up quickly. A highly visible widening of income differentials of this kind is likely to be very unpopular with urban workers and party veterans.

Party conservatives have already fought a rear-guard action against *glasnost* and the relaxation of controls over literature and the theater. Now Gorbachev has tabled the issue of competitive elections for party officials from the shop floor to at least the republic level. In the eyes of most party leaders, a little democracy at the local level is probably acceptable. But the idea of risking their own positions in a secret ballot will surely be opposed, and not just as a matter of self-interest. Elections inevitably evoke the specter of factionalism that would undermine the top-down direction of the society and the economy that has prevailed under the guise of democratic centralism for 60 years. No doubt the leadership would do its best to control the election process, but its success would by no means be assured. For one thing, Gorbachev does not now have firm control over the regional party apparatus. Moreover, the idea of voting on Russian and non-Russian candidates in places like Lithuania, Uzbekistan, and Kazakhstan conjures up all sorts of unpleasant possibilities. How far Gorbachev means to go with participatory government and democratic direction of party affairs is not clear. Nonetheless, if he is serious he could misplay his hand and become a victim of a Central Committee election for the first time in two decades.

The Influence of External Developments

Clearly, external developments impinge on all of the decisions Gorbachev might make. The connection is direct in matters of resource allocation, but even progress on political and cultural reforms depends on the General Secretary's authority, which can be strengthened or eroded by what happens to his foreign policy initiatives. This dependence can be seen in starkest terms by postulating two quite different scenarios.

In the scenario that gives Gorbachev the greatest scope for action, the USSR reaches an agreement with the United States that reduces strategic offensive forces and defers testing of a space-based ABM until the 21st century (although a further weakening of Congressional and popular support for the US administration's defense programs would serve much the same purpose). The agreements in turn help to pave the way for a substantial increase in East-West economic relations, including liberal credits and a

rising number of joint ventures. Eastern Europe shares in the revival of commercial relations, reducing the economic burden in the Soviet Union of supporting East European living standards. Finally, Gorbachev succeeds in solidifying a friendly regime in Kabul that is able to reduce the scale of Afghan resistance to a tolerable level, and better relations with China and Japan make reductions in military forces in the Soviet Far East more palatable to both the military and civilian defense factions.

A realization of this scenario or major elements of it obviously would contribute greatly to Gorbachev's program for the USSR. It would give the leadership the *peredyska* (breathing space) necessary to keep rising military budgets from choking off the reconstruction of the economy. It would also—although this is of lesser importance—permit some demobilization of people in their prime working age at a time when the Soviet Union is finding it difficult to man the new machines appearing in the country's factories. The expansion of trade and the availability of credits would in turn give Gorbachev a safety valve that could be used if the pressures built up by domestic investment programs or economic decentralization result in shortages of the kind that throttled the economy in the late 1970s and early 1980s. It would also increase access to Western technology, aiding Soviet efforts to improve the quality and efficiency of domestic production. Less tangible but possibly just as important would be the impact of foreign policy successes on Gorbachev's authority in the party. The scenario outlined here would certainly soften debate in the Politburo over resource allocation, especially as it affected defense, while strengthening the General Secretary's hand in pushing for more far-reaching political and economic reform—should he decide to do so.

A distinctly unfavorable foreign policy scenario, however, can also be postulated. Arms control negotiations go nowhere, and early deployment of some version of a US ABM system seems assured. Defense spending in the United States (aside from SDI) and non-US NATO rises in real terms. East-West political differences undermine Moscow's programs for

joint ventures and expanded trade and foreclose the possibility of using credits to generate the rising import surpluses that would be useful in offsetting some of the shortfalls in domestic economic performance. This bad-news scenario would probably lead to a new upswing in Soviet military spending. Arguments for the requirements of industrial modernization would be unlikely to prevail against the supporters of larger programs for conventional forces and a step-up of programs to find an effective ABM and to counter an emerging SDI threat from the United States.

The impact of higher defense procurement on Gorbachev's economic program depends on a number of things aside from how fast procurement grows. Of particular importance will be the degree of success the USSR will have in holding down requirements for new capital stock by increasing the productivity of new machinery and conserving energy and materials in the production process. But a sharp rise in the rates of growth of military purchases from the machine-building sector would probably bring the scale of modernization down to the levels of the late Brezhnev years. Thus, favorable developments in the foreign policy arena could well be a necessary, although not a sufficient, condition for the success of Gorbachev's program.

Gorbachev's Priorities

Gorbachev cannot work out the next steps toward renewal at his leisure. The decisions that have to be made during the remainder of the 1980s are likely to force his hand, as will the necessity of coping with economic difficulties and political opposition. Developments during the past year have increased the chances that he will act boldly to sustain the momentum of his program.

Defense and Investment. Because he seems determined to protect a modernization program that is already underfunded and because the milestones for finishing the 1991-95 economic plan are fast approaching, Gorbachev is likely to seek arms control agreements in the last two years of the Reagan administration rather than wait for the next election. Should economic growth flag in the next year or so, he would be even more tempted to constrain defense in favor of increasing investment. If, however, NATO defense programs run out of steam, the urgency of

arms control for his program will diminish in the short run. But the USSR will still be interested in arms control over the longer term because it will want to protect against adverse military-technological developments.

More Radical Economic Reform. The foundations of what one of Gorbachev's principal economic advisers calls a "third wave" of reform are under study. It will take about three years to work out the interconnections among economic decentralization, a more flexible and decentralized system of price setting, and the legal and financial sanctions necessary to discipline individual enterprises. Whether a plausible package can be put together is by no means certain. Nonetheless, the weaknesses of the reform measures undertaken thus far are likely to become clearer over the next few years. Judging by the advice he is getting and his aggressiveness in other areas, Gorbachev, more likely than not, will move forward rather than retreat and insist on carrying out the more radical reform outlined in the guidelines accepted at the June 1987 plenum of the Central Committee.

Outflanking Opponents in the Party and Government. Gorbachev sees *glasnost* and controlled democracy as a way of exposing and disciplining those who will not or cannot implement his program. Some form of contested elections for party and government posts almost certainly will be decreed. In the economy, workers probably will have a greater say in choosing trade union officials, foremen, and even managers. The General Secretary has risen in the pulpit on this issue:

We need democracy like air. If we fail to realize that and even if we do realize that but make no serious steps to broaden it, to advance it and draw the country's working people extensively into the reorganization process, our policy will get choked, and the renewal will peter out, comrades.

*Gorbachev's closing remarks to the plenary meeting of the CPSU Central Committee
28 January 1987*

Whether he is a true believer or not, Gorbachev will very likely manage the democracy campaign in a way that helps him identify and get rid of his opponents. The reported decision to draft a new party history and selected liberalization of censorship could be very useful in this effort. [REDACTED]

The Consequences of Failure. Gorbachev already has asked the military and the population to curb their appetites in return for more later. If his programs do not work out, other leaders could appeal to these constituencies. The risks in a more radical reform and a reformation of the social contract are that confusion, antiplan behavior, and worker discontent will give potential opponents a platform to stand on. Another danger to Gorbachev's position could be the loosening of censorship over the written and spoken word and the promotion of democracy. If it suspects that this process is getting out of control, the party could well execute an abrupt about-face, discarding Gorbachev along the way. Thus, by his aggressiveness, Gorbachev has increased the dependence of his position on the fortunes of his programs for the economy and society. [REDACTED]