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Soviet Economic Problems

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## NATIONAL INTELLIGENCE ESTIMATE

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# Soviet Economic Problems

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## SOVIET ECONOMIC PROBLEMS

### THE PROBLEM

To assess Soviet economic capabilities to meet the demands of major economic programs over the next few years and to estimate the future course and implications of economic policy.

### CONCLUSIONS

A. The Soviet leadership, in its across-the-board challenge to the US world position, has in recent years taken on heavier commitments than ever in the fields of general economic growth, modern armaments, space achievements, living standards, and foreign aid. The Soviet economy is very large and is still growing at a substantial rate, but the competing demands generated by this broad array of objectives have imposed increasingly severe pressures on Soviet resources. (*Paras. 1-2*)

B. While some of the difficulties now being experienced can be traced back to Khrushchev's excessive optimism of 1957-1958, their most important cause is the acceleration of military and space spending. Over the last four years, these expenditures have grown at a considerably faster rate than the economy as a whole, and military and space programs have had first call on the scarce resources of high-quality manpower and materials. The resulting impact has been felt both in industry, where growth rates have declined, and in agriculture, where output has failed to rise above the 1958 level. In consequence, improvements in living standards have slackened, and general economic growth has fallen off from the high rate achieved during most of the 1950's. (*Paras. 3-9*)

C. The Soviet leaders seemed to avoid difficult economic decisions during 1962. Instead, they introduced a series of ex-

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pedients, primarily organizational and administrative in nature, which they hoped would restore the momentum of the economy and relieve them of the need to sacrifice or stretch out their major programs. In early 1963, however, there are signs that they have reappraised their economic position and have decided to reaffirm, and perhaps to strengthen, the primacy of defense over other sectors of the economy, particularly those related to consumption. (*Paras. 10-17*)

D. We believe that, in the short run, the general pattern of resource allocation developed over the past several years and reasserted this year is unlikely to be greatly altered. As a result, however, the USSR will face accumulating difficulties in its efforts to raise living standards, and perhaps a further slowdown in the tempo of general economic advance. Future economic policy may be shaped by a variety of events, such as manifestations of consumer discontent and developments in Western military strength and economic expansion. The allocation of resources will probably be a central issue in the political contention which we anticipate after Khrushchev's departure. At some point, economic stringencies could lead the Soviets to explore political ways of reducing the burden of armaments, but present indications do not point in this direction. (*Paras. 18-27*)

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## DISCUSSION

### I. INTRODUCTION

1. The Soviet economy, viewed from the most general standpoint, presents a piebald pattern of impressive strengths and patent weaknesses. In industry, output per worker is roughly equivalent to that of the leading countries of Western Europe, but in agriculture it is half or less. With its output valued in dollars, the economy is supporting military expenditures which are about four-fifths those of the US and a gross annual investment approximately equal to that of the US, yet consumption per capita is less than one-third of the US level. Unlike that of the US, the Soviet economy consistently operates near its capacity; thus there is little or no cushion to meet additional demands. The growth of the economy continues at high though no longer exceptional rates; in the last three or four years, gross national product (GNP) has increased on the average about five percent annually, and industrial production by seven to eight percent annually.

2. While this general pattern of strengths and weaknesses has long been characteristic of the Soviet economy, it is our judgment that the Soviet leaders are now facing particularly difficult economic problems. The leadership, in its across-the-board challenge to the US world position, has taken on heavier commitments than ever in the fields of general economic growth, modern armaments, space, living standards, and foreign aid. At the same time, the Soviet growth rates cited above, although impressive in comparison to US performance over the last 10 years, are not as high as those recorded during most of the 1950's, when the yearly increase of GNP averaged about seven percent and industrial production grew by about nine percent annually. The regime's current call for tighter economic controls, for higher efficiency, and for new forms of organization and planning testifies to an increasing awareness of stringencies. The decisions facing the Soviet leaders are becoming more difficult and require them either to narrow their array of objectives or to extend their earlier expectations to a somewhat more distant future.

### II. THE RECENT RECORD

3. Some of the difficulty now being experienced can be traced to a set of decisions and targets established in 1957-1958. At that time, Khrushchev had recently defeated the "antiparty group" and achieved a commanding position, and the presumptions underlying the Seven-Year Plan (1959-1965) bore the marks of his characteristic optimism. In agriculture, he apparently believed that, with the initial successes of the New Lands and other post-Stalin programs, a momentum had been achieved which would carry farm output forward without further large injections

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of capital. Agricultural production in 1958 did in fact rise by a startling 13 percent, but this was due primarily to the coincidence of good to excellent weather in all major farming regions.

4. In industry, Khrushchev appears to have relied heavily on future gains in efficiency resulting from the modernization of factories and the administrative reorganization which he had pushed through, against strong political opposition, in 1957. Conscious of the manifold inefficiencies and backwardnesses of Soviet industry, and confident of his ability to overcome them, he launched a major campaign for mechanization and automation and instituted a reduction in the work week. The latter decision seems to have been based on excessive hopes for a rise in man-hour productivity and has accounted for some of the decline in industrial growth rates.

5. Khrushchev's optimism partly explains another, probably more important reason for current difficulties: the apparent failure of Soviet planners correctly to foresee future military demands and their impact upon the economy. In 1956 and 1957, reductions in military manpower and arms output brought down defense spending, and this was an important factor in maintaining growth in other sectors. Thereafter, everything, including Khrushchev's own foreign policies, has conspired to increase the military burden, and estimated military expenditures grew by about one-third between 1958 and 1962 while GNP was rising by slightly over one-fifth. The introduction of advanced weapons and equipment on a large scale required heavy new expenditures. Western resistance to Khrushchev's Berlin demands of November 1958 obliged the USSR to build up its strategic strength if it were to make credible its threats of unilateral action. The military leadership balked at Khrushchev's plans to save money by reducing conventional forces and particularly ground troops, and a rekindling of the Berlin crisis in 1961 led to shelving that project. The continued growth in Western military strength throughout this period, and the damage done in 1961-1962 to the image of Soviet strategic power, have put the USSR under increasing pressure to raise defense expenditures.

6. The growing military burden, together with rising space expenditures, has in recent years increasingly held back the advance of the Soviet economy. This effect is particularly noticeable in the industries producing machinery and equipment, where weapons and other military hardware compete directly for resources with industrial, agricultural, and transportation equipment and consumer durables. The production of machinery and equipment for nonmilitary users, which increased by an estimated 14 percent or more annually in the years 1955-1958, grew at a rate of only nine percent or less in the ensuing years. Production for the military, on the other hand, which declined slightly in the earlier period, rose by an estimated average of 13 percent per year after

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1958. Moreover, it seems certain that orders for military and space programs have enjoyed priority in the competition for specialized, high-grade resources, such as design engineers, highly trained technicians, and high-quality materials and components.

7. We estimate that military and space programs consumed in 1962 over 35 percent of the total Soviet production of durable goods, as compared with about 25 percent in the US. The effects of the military and space programs are discernible in the deliveries of machinery to agriculture and in the general trends in the equipment portion of investment. The production of trucks, tractors, and other machinery for agriculture fell by nearly two-fifths between 1957 and 1959 and had regained only 80 percent of the earlier level by 1961. Investment in machinery and equipment increased by 16 percent annually from 1955 to 1958 but only an average of about 9 percent per year subsequently. This factor, along with difficulties in the planning and completion of new construction, explains the drastic slowdown in the growth of investment, which rose by only 4 percent in 1961 and 4 or 5 percent in 1962 after increases of 14 percent or more in the years 1956-1959.

8. Under the impact of these problems, the post-Stalin improvement in Soviet living standards has begun to slow down perceptibly. The leveling off in agriculture, where net output in 1962 was about equal to that of 1958 but had to support 14 million additional people, is the major cause of this slowdown. In addition, however, the continued low priority of light industry in the competition for modern equipment and skilled labor has kept this a backward sector producing shoddy goods which frequently go unsold despite the continuing rise in money incomes. The annual volume of new housing has remained roughly stationary over the last three years.

9. While per capita consumption is still rising, the declining pace of improvement and the attendant growth of inflationary pressures have not been without repercussions. Certain price and tax measures introduced in 1962 created strong popular resentment and raised fears that consumer interests would be further circumscribed in the future. This was particularly evident in the provincial cities which have traditionally lagged far behind Moscow, Leningrad, and Kiev in quality of consumer goods and the amenities of life; in several locations the decision of June 1962 to raise meat and butter prices was followed by demonstrations and even riots on the broadest scale in many years.

### III. CURRENT POLICY RESPONSES

10. Despite the pressures generated by these problems and the fact that the rate of economic growth has declined, the Soviet leaders have been reluctant to accept the conclusion that some programs would have to be sacrificed or stretched out. Instead they have devised a number

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of expedients intended to boost the productivity of the land, labor, and capital at their disposal. Measures were taken in 1962 to bring order into the field of construction, where chronically inefficient building practices and poor coordination between construction work and the delivery of equipment had further increased the volume of unfinished work in 1961. By placing a moratorium on many new starts and suspending work on low priority projects in order to permit the concentration of resources on completing major projects, the Soviet authorities achieved some success in bringing these projects into operation, but at considerable additional cost. Because of a lack of skilled labor and other inputs, a plan for added shifts in machinery plants has so far brought few results, although over the next several years this scheme may enable the USSR to get more production out of its existing factories.

11. In agriculture, Khrushchev launched in late 1961 yet another of his sudden campaigns to bring "hidden reserves" into action. This time he called for planting high-yield crops on the greater part of acreage previously lying fallow or sown to grasses or oats. He was unable, however, to secure the additional inputs of machinery, fertilizer, and skilled manpower needed to take full advantage of this new pattern of land use. Meanwhile the plowing up of fallow in the New Lands is likely to intensify the problem of weed control, moisture preservation, and soil erosion which already plague these areas; elsewhere, the cultivation of areas now under rotational grasses will deplete the soil unless there is applied a great deal more lime and fertilizer than is presently available.

12. In the military and space fields, expenditures mounted by an estimated 10 percent in 1962, primarily because of the growing deployment of offensive and defensive missiles, production of their nuclear warheads, and research and development of newer weapons systems. Since we have little evidence bearing upon recent decisions concerning future programming, we do not know whether economizing measures of any sort were devised during the year. Statements by military leaders suggest, however, that they are continuing to press for higher military allocations in order to cover growing expenditures on advanced weapons systems without offsetting reductions in expenditures on conventional forces. One element in the decision to undertake the Cuban missile venture may have been the prospect of getting a quick increase in the strategic threat posed against the US at comparatively low cost. Whether or not this was the case, the Soviet leadership is still faced with the difficult question of how to achieve, within the USSR's economic possibilities, a strategic posture impressive enough to support the full range of its foreign policy objectives.

13. The November plenum launched a familiar response to economic problems in the form of an administrative reorganization of both the party and government. This new scheme greatly reduced the role and number of regional economic councils, which were the core of the 1957

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reorganizations; their activities were placed under closer central direction and their responsibilities for construction and industrial research were transferred to central agencies. Most important, immediate supervision of enterprises was transferred to local party bodies. These party committees in turn have been divided into two hierarchies, one for industry and the other for agriculture, and have been charged with basic responsibility for plan fulfillment, changes which reflect Khrushchev's faith in the ultimate ability of the party to correct faults in the economic system. In an associated move a joint party-state control organization was established to combat falsification, speculation, and other illegalities which plague the economy. All these and other related changes continued the process, which began several years ago, of modifying Khrushchev's 1957 administrative decentralization.

14. These shifts testify to Khrushchev's continued belief that new administrative arrangements can be used to unlock "hidden reserves" throughout the economy and to help bring about a return to the growth rates of the 1950's. We believe that, on the contrary, Soviet enterprises will be faced with more administrative confusion, multiple and uncoordinated plans from different levels, and inconsistencies between production targets and material supply. Thus, in our view, the new schemes are more likely to increase than to diminish the inefficiencies of administering a large planned economy. Further, they increase the likelihood of institutional conflicts between the party and the economic administration, and perhaps within the party apparatus as well.

15. In undertaking this major reorganization, the Soviets appear to have set aside any large-scale introduction of reforms which would deal more effectively with these problems. Soviet economists have in recent years developed and publicized various schemes to rationalize the operation of the economy. Some, such as Professor Liberman, have suggested that enterprise directors be granted greater latitude in choosing the ways of reaching centrally-set output goals; others have argued that pricing systems should be developed and allowed to play a larger role in determining the allocation of resources. But such proposals encounter bureaucratic inertia and ideological objections; moreover, they contain some danger of eventual encroachments on the leadership's powers to enforce its priorities, and the November plenum merely allowed for continued discussion and small-scale experimentation. Similar objections prevent the leadership from easing its problems by allowing a greater latitude to private economic activity. In fact, the stress in recent years on "building communism" has been accompanied by new restrictions on private ownership of livestock and private housebuilding which have significantly held back progress in both animal husbandry and housing construction.

16. Over the last three years, Khrushchev has repeatedly argued the case for the consumer. He has urged specifically that more funds be devoted to agriculture and has warned that failure to satisfy the growing

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demand for consumers goods could lead to strong inflationary pressures and a drop in worker morale. We do not know how large a shift in allocations he has had in mind; it may in fact have been relatively small, for Khrushchev like his colleagues is strongly devoted to the goals of continued industrial growth, a strong military establishment, and Soviet pre-eminence in space. In any event, his past proposals to divert more funds to agriculture were for the most part shelved and the moderate increases in net agricultural investment achieved in 1962 and planned for 1963 fall far short of the effort necessary to initiate sustained growth in this sector.

17. In his speech of 27 February 1963, Khrushchev strikes a quite different note. Rather than urging a higher priority for consumption, he now is concerned to warn Soviet consumers of coming disappointments and to forestall criticisms by citing defense needs. His statements suggest that the leadership has recently reappraised its economic possibilities in the light of the shortcomings of the last two years and, perhaps, the strategic situation in the wake of the Cuban missile crisis. His strong reaffirmations of military priorities reflect, at a minimum, a determination to proceed with programmed expenditures and, beyond this, a possible decision to increase military spending above previously planned levels. The recent establishment of a Supreme Economic Council for industry and construction and the appointment of a specialist in defense industries as its head could reflect such a decision. In any case, Khrushchev indicates that, at least for the time being, there can be no substantial increases in allocations to agriculture and that the program to raise living standards will be further delayed. While he reaffirms the objective of rapid industrial growth, in our view it is also possible that investment for general industrial expansion will fall further behind schedule.

#### IV. THE OUTLOOK

18. In spite of their severe economic problems, the Soviets are still maintaining a high rate of investment—currently about 30 percent of GNP—which will continue to provide for substantial growth. The entry of larger postwar age-groups into the work force, together with an end to further reductions in the work week, will ease the now relatively tight labor supply, and the number of experienced engineers and technicians is constantly expanding. Particularly acute construction difficulties probably will be overcome, although a certain chronic disorder will continue. A year of favorable agricultural weather is overdue, and when it occurs, will provide a fillip to this sector and to the economy as a whole.

19. These factors seem insufficient, however, to produce a significant rise in the rate of economic growth. Given the ambitious long-run objectives of the leadership, the USSR's basic need is for more investment

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to provide the higher rates of growth which would permit a fuller satisfaction of competing demands. In the short run, however, any substantial increase in investment could only be made at the expense of the military and space program or the consumer. In 1956 and 1957, additional investment funds and manpower were made available by a reduction in defense spending; subsequently, when military and space spending rose, a slowdown in the growth of consumption permitted investment to keep growing. In the last two or three years, however, not only have difficulties accumulated in the consumption sector, but the growth of investment itself has slowed.

20. This situation must inevitably focus the leadership's attention upon the military budget and space program. Several elements are likely to be subject to continuing review. One is military manpower and conventional weapons, where Khrushchev once claimed significant savings were possible. Another is the manned lunar landing program; the Soviets have a strong incentive to beat the US in this effort, but Khrushchev and others have complained of the great expense of such a project, and the USSR is not yet publicly in the race. A third is the long-range striking forces, on which it may be possible to hold down expenditures by stressing qualitative improvements, such as very high-yield warheads or a greater missile load per submarine, rather than the continued proliferation of delivery vehicles. A fourth is the anti-ballistic missile program, in which the Soviets face a choice among deployment now of a costly existing system, deployment later of an improved but probably even more expensive system, or no deployment while research and development continues to seek a breakthrough which would reduce costs, provide more certain effectiveness, or both. Recent Soviet statements indicate that military and space programs continue to enjoy a high priority, but future stringencies may lead the USSR to reassess them at a later date.

21. Should the Soviets decide that growth rates must not fall below the level of the past two or three years, then it is probably necessary that expenditures on defense and space increase no faster than GNP and that these programs consume no more than their present share of the total output of machinery and equipment. It is likely that, under such a pattern of allocations, the present growth rate of GNP could be maintained well into the second half of the decade. At the same time the leadership probably could carry out a course of moderate but sustained improvement in consumer welfare.

22. Alternatively, the Soviets might decide to continue to increase military and space expenditures at a rate which takes a growing share of GNP and machinery production. In these circumstances, investment in the industries supporting defense and basic growth almost certainly would hold priority in the competition for the remaining resources, and the consumer would feel even more strongly the effects of continued

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underinvestment in agriculture, light industry, and housing. Under this pattern of allocations, it would be more difficult to sustain present growth rates, not only because of greater stringency in investment resources, particularly machinery and equipment, but also because of the possible effects, to which Khrushchev has frequently drawn attention, on worker morale and productivity.

23. For the immediate future, we believe that the Soviets are more likely to respond to their economic problems with minor adjustments and further expedients than with any radical new decisions. The record of recent years suggests that the contending arguments in favor of investment, of defense, and of consumption are all strongly felt within the leadership. But current evidence indicates that no new restraints on military and space spending are in view, and that administrative pressure and reorganization are regarded as the chief means of improving the performance of the civilian sectors. If we have correctly assessed the state and prospects of the Soviet economy, however, the Soviets will find before long that these expedients are unsatisfactory and that they are facing slower tempos of advance.

24. The Soviets continue to use foreign trade as a means of alleviating some of the strains in their economy, especially through the import of capital goods from the industrial West. Current and prospective trends in Soviet foreign trade suggest, however, that domestic difficulties in certain sectors may be aggravated by growing export demands. Shipments of civilian machinery and military hardware to the underdeveloped countries will represent a small but increasing claim on production capacity which is already under strain from high priority internal programs. At the same time, Soviet indebtedness to Western Europe and Japan, primarily for imports of capital goods, has been growing rapidly, and the USSR will face the problem of generating an export surplus sufficient to meet these obligations.

25. There is a chance that events might precipitate important new decisions affecting the allocation of resources. The immediate outlook for the consumer, for example, is poor, and it is possible that manifestations of discontent will match or even exceed the scale of 1962. The leadership's response to such a situation could range from a significant upgrading of consumer priorities to reliance upon repressive policies. The course of external events will almost certainly have an influence upon policy choices. East-West tension and an improvement of Western defenses, for example, would strengthen the argument for higher military spending, while economic expansion in the US and Western Europe would bolster arguments for a higher rate of investment to match the performance of the capitalist economies. Even the relatively small foreign aid program might be curtailed in the search for additional resources, particularly if political trends in the under-

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developed countries fail to meet Soviet expectations or to produce promising new opportunities.

26. One conceivable Soviet response to economic strains would be for the USSR, at some point, to consider political ways of reducing the burden of armaments. Such a reduction could be sought either by arms control agreements or by working to bring about a more relaxed international atmosphere in which the USSR felt able to cut its military spending without jeopardizing its security or giving up its political objectives. The first of these courses would require the USSR to move some distance closer to Western terms for agreement. The second would require a protracted period of fairly genuine detente, in which the USSR forebore from policies alarming to the West in hopes of inducing its opponents to reduce their defenses. Present indications do not, however, point in either of these directions. While economic pressures may lead the Soviets to explore these possibilities during the next several years, any actual shift of policy would also depend on a variety of political considerations and even on fortuitous events which could confront the USSR with unexpected problems or opportunities.

27. In the contention for power which we anticipate after Khrushchev's departure, one leader might try to build popular support by arguing for improvements in welfare, while another might court a military following by sponsoring high allocations to defense. The questions of decentralization and liberalized methods of managing the economy might arise at that time as factional issues. We do not know which particular questions will come to the fore or how they will be resolved, but we think it certain that economic issues will be a central element in the succession struggle, which itself might lead to important changes in the Soviet system.

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