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Implications of a Surging Soviet Budget Deficit

An Intelligence Assessment

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Implications of a Surging Soviet Budget Deficit

An Intelligence Assessment

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April 1989

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Implications of a Surging Soviet Budget Deficit

Key Judgments

*Information available
as of 31 March 1989
was used in this report.*

The USSR is running a huge budget deficit, and its leaders are deeply concerned about the economy's growing financial imbalance. Soviet officials claim that the deficit has stabilized since 1985, but by our estimates it has soared from 25 billion rubles in 1985 to over 80 billion rubles in 1988. Moreover, if the budget plan approved in October 1988 were implemented, we estimate that the deficit would surge to about 125 billion rubles in 1989, some 13 percent of Soviet GNP. (The highest US budget deficit—in FY 1986—represented 3.5 percent of US GNP.)

Soaring spending and stagnant revenues are behind the rise in the deficit. Until 1989 General Secretary Gorbachev steadily boosted investment spending to support industrial modernization, maintained growth in defense spending, tolerated increases in state subsidies, and confronted unanticipated problems such as the 8-billion-ruble Chernobyl cleanup. His antialcohol campaign, the fall in Soviet foreign trade revenues, and profit and turnover tax shortfalls stemming from sluggish economic growth, in turn, undermined the revenue base.

Gorbachev and his advisers could clearly see the deficit trends but were unwilling—or unable—to force spending cuts. In 1988 Soviet officials not only met with resistance when they tried to institute modest cuts but, in the face of potential consumer unrest, launched new spending programs and postponed elimination of the massive consumer subsidies, which account for about 20 percent of the budget. By early 1989 Gorbachev apparently had mustered the political clout to institute substantial spending cuts while accelerating the process of "reorienting" the economy to the consumer. Gorbachev announced a 14.2-percent reduction in defense spending by 1991, and a government commission has called for cuts of 6-7 billion rubles in 1989 investment.

In March 1989 Finance Minister Gostev announced that these cuts and other measures would reduce the 1989 deficit by 30 billion rubles, but, even if realized, they are too little and too late to defuse growing inflationary pressures. As Soviet incomes have surged, *perestroika* has failed to deliver correspondingly increased supplies of goods and services:

- Prices are rising ever more rapidly where they are uncontrolled—especially for food. Inflation will redistribute income from pensioners and others on fixed incomes to those whose incomes will rise with inflation, such as members of cooperatives, private-plot farmers, second-economy operators, and state workers whose skills are in demand.

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- Where prices are controlled, goods have disappeared from store shelves, queues are longer, and rationing is much more widespread. By mid-1988, eight of the USSR's 15 republics had introduced rationing to distribute scarce food items more equitably.
- Frustrated consumers are adding to their personal savings at record rates, contributing to a huge "overhang" of purchasing power that will sustain inflationary pressures for years to come.

Consumer complaints are sure to intensify, as will the tendency for many Soviet citizens to blame their situation on *perestroika* and Gorbachev.

While Moscow now appears to have given priority to reducing the deficit, its enormous size and the limited options available to the leadership will make it exceedingly difficult to restore financial balance. The proposed spending cuts notwithstanding, deficits will remain high until the Soviets take such painful steps as sharply cutting state subsidies for consumers. In the meantime, the eroding value of the ruble threatens efforts to improve labor productivity, implement retail price reform, and increase work incentives, while maintaining an effective safety net. Gorbachev has only limited maneuvering room as he weighs the political and social costs of the "cures" against the economic costs of the "disease."

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Scope Note

A previous Research Paper [] document-
ed the existence of a steep rise in state budget deficits in the USSR since
1985 and its attendant implications for Soviet economic performance.

The Soviets have subsequently acknowledged the existence of a large
budget deficit and linked it to increasing inflationary tendencies in the
economy while claiming that the deficit problem is slowing the process of
economic restructuring.

This paper presents our estimate of the 1989 deficit, explores Moscow's
motivations for increasing deficit spending, compares the deficit figures
released by the Soviets with our estimates, and discusses why the regime is
likely to take steps specifically to deal with the deficit problem in the near
future. The discussions of inflation in the USSR in the 1930s and the 1947
price reform are largely taken from Franklyn D. Holzman, "Soviet
Inflationary Pressures, 1928-1957: Causes and Cures" in *The Quarterly
Journal of Economics*, Vol. LXXIV, No. 2, May 1960; and Franklyn D.
Holzman, *Soviet Taxation*, Harvard University Press, Cambridge, 1955.

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Implications of a Surging Soviet Budget Deficit

The Deficit Problem Takes Center Stage

The Soviet economy's financial imbalance is crowding out other priorities on General Secretary Gorbachev's economic agenda, including modernization, economic reform, and even the production of more consumer goods and services. Gorbachev recently stated in a January speech that resolving the economy's financial problem is the most urgent and acute task facing the leadership. Similar warnings have been sounded even more recently by leading Soviet reform economists Leonid Abalkin and Abel Aganbegyan. Nonetheless, just last October, Moscow proposed a 1989 budget that greatly increases the state budget deficit—an action that clearly is hard to reconcile with increased alarm about the financial condition of the economy. This paper explores some of the issues behind these developments and Soviet economic prospects if Moscow maintains its present course.

Grudging Soviet Acknowledgment

For more than 60 years, with the exception of the war years 1941-43, the Soviets routinely reported a surplus in the state budget (see inset). As recently as October 1988, the official annual budget fulfillment report showed a 5-billion-ruble budget surplus for 1987. Even as the 1987 surplus was being announced, however, Minister of Finance Gostev was acknowledging that the budget was really in deficit. He suggested that deficits peaked about 1985 and that they were having an inflationary effect on the economy. Moreover, during his October budget presentation to the Supreme Soviet, in an unprecedented peacetime announcement, he projected a 35-billion-ruble deficit for 1989. His report was anticipated by a TASS announcement in September that said, for the first time, deputies would discuss the budget deficit at the Supreme Soviet meeting.

Scope of the Soviet Budget

The Soviet state budget is compiled by the Ministry of Finance. It is a national consolidated budget that includes the all-union as well as the republic and local government budgets. State spending represents some 70 percent of national income as measured by official data. The budget provides funds for capital investment, higher education, health, recreation, pensions, and many other activities that are usually financed largely from the private sector in Western economies.

The budget, the central component of the overall state financial plan, reflects in value terms the physical priorities of the annual economic plan. Both the plan and the budget are presented and approved at the end-of-year meeting of the Supreme Soviet. The financial resources are then allocated to the subordinate agencies, and the expenditures are monitored by the Ministry of Finance and the State Bank.

Gostev's acknowledgement of a budget deficit followed a year of hints by officials and more forthright assertions by Soviet economists that all is not well in the Soviet budgetary and financial system. In a June 1987 speech to the party leadership, Gorbachev made an oblique reference to unspecified budget problems in the Brezhnev era. Gorbachev said that, under his predecessor, the budget looked favorable on the surface because of revenue—from heavy taxes on oil exports and alcohol sales—that had no economic or social justification. In a speech to party leaders in February 1988, he admitted that, since 1985, the

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economy had come up against a "very serious financial problem" that he did not identify but which he linked to the loss of revenues from imports and reduced alcohol sales. Finally, in July 1988, the General Secretary referred specifically to a deficit in the state budget, stating that the 1989 plan should begin to reduce it and that, "in the initial period, we could even reduce the volume of capital investment."

Soviet economists were more willing than party officials during this time to pinpoint an actual deficit as the "budget problem" and to discuss its pernicious effects. For example, in September 1987 Oleg Bogomolov, Director of the Institute of the Economics of the World Socialist System, blamed "the deficit in the State Bank cash balance" as a major cause of inflation. In April 1988 Nikolay Shmelev provided the most graphic discussion up to that time of the budget deficit and added that it "is today covered by that supremely dangerous, unhealthy means—the mint."

Why Did the Leadership Publicize the Deficit?

To some degree, publicizing the deficit appears to be simply a manifestation of *glasnost*. However, there were probably some strong political motivations as well. Specifically, Gorbachev may have felt that publicizing the deficit would put pressure on those in charge of long-protected areas of spending such as agriculture and defense. In this way, acknowledging the deficit could help him obtain his priority goals for the economy.

Indeed, a number of Soviet commentators have raised the budget deficit as an argument for reducing agricultural investment and examining defense spending levels for possible cuts. Over the past year a barrage of high-level criticism was directed at the wasteful use of investment resources in the production of huge numbers of inefficient agricultural machines. Economists Otto Latsis and Yegor Gaydar decried the practice of "throwing additional budget funds" at agriculture in the November 1988 issue of *Kommunist*. Nikolay Shmelev invited attention to defense

expenditures in his April 1988 *Novy mir* article. And Leonid Abalkin, Director of the USSR Academy of Sciences Economics Institute, suggested that "considerable resources" could be released from defense during a recent interview in *Trud*. Gorbachev, himself, told a gathering of scientific and cultural figures in early January 1989 that the question of financial balance has become so acute that some fairly "sharp and decisive measures" affecting budgetary expenditures may be required, and he specifically cited the need to examine expenditures on defense.

Since the first of the year, high-level attention to the problem has been intensifying. The Soviet press announced that, at a 16 February meeting, the Politburo proposed adoption of "urgent" measures to cut state budget spending for investment, defense, and administration in order to reduce the deficit. One week later, in Kiev, Gorbachev said that work was being completed on a package of measures to restore health to the country's finances.

The Truth, but not the Whole Truth

Although the Soviets now acknowledge that a deficit in the state budget has existed for many years, the problem is more severe than admitted, particularly in the years since Gorbachev came to power. Despite the official figures showing a balanced budget in the past, we estimate that, during the 1970s and early 1980s, the government was running annual deficits of about 10-15 billion rubles. While the Soviet announcements last fall claimed that the budget deficit has stabilized since 1985, we estimate that the deficit began to escalate sharply from that year, soared to over 70 billion rubles in 1987, and increased to over 80 billion rubles in 1988 (see inset).

Spending increased rapidly since 1985 because of:

- *Gorbachev's ambitious investment program*. State capital investment in 1986 and 1987 was 172 and 183 billion rubles, respectively—increases of 14 billion and 25 billion rubles over that of 1985.

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Estimating the Budget Deficit

Official Soviet budgets have almost invariably shown a surplus because they include short-term loans from the State Bank as a source of revenue. The 1989 budget plan lists "resources of the statewide loan fund" as providing more than 60 billion rubles of revenue. To put the budget in Western terms, which exclude such loans, revenues must be recalculated from detailed Soviet data on tax collections and from Western estimates of Soviet revenue from foreign trade. This procedure indicates that the USSR was running deficits of about 10-15 billion rubles throughout the 1970s and early 1980s. Only since 1985 have the deficits increased sharply as government expenditures soared and revenues stagnated.

State revenues have been curtailed by:

- *The antialcohol campaign.* From a variety of Soviet official and unofficial figures, we estimate tax losses from the reduction in alcohol sales have amounted to about 30 billion rubles over the past three years.
- *The collapse in world oil prices in early 1986 and the subsequent reduction in imports of consumer goods, which are heavily taxed when sold domestically.*² Hard currency oil exports fell to \$7 billion in 1986, less than half the annual average during 1982-84, and Moscow reduced consumer goods imports by 10 percent that year.

These trends are reflected in the 1989 budget plan (see figure 1). Expenditures are to rise by 11.5 percent, or 50 billion rubles, primarily because of increased spending for health, education, science, and subsidies. Since the plan was approved, officials have noted that 8-15 billion rubles in additional expenditures, spread over several years, will be required for reconstruction following the earthquake in Armenia. Meanwhile, we estimate revenues will increase by only 2.5 percent, or 9 billion rubles, in 1989. The Soviets project that their largest tax source—payments from profits—will not grow at all, apparently reflecting the ability of enterprises to retain more profits under the economic reform. Even with some increase in alcohol sales, turnover taxes, the next largest source, are projected to increase by only 5 billion rubles, or about 5 percent.

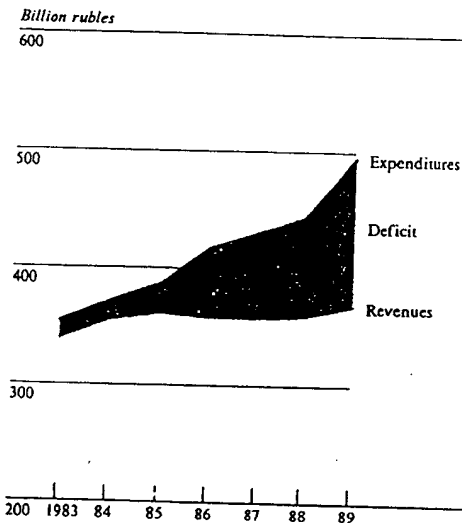
Thus, in contrast with Gostev's projection of a 35-billion-ruble deficit in 1989, we estimate that the announced budget would produce a deficit of 126 billion rubles this year, some 13 percent of Soviet GNP (see figure 2 and table 1). (The highest US budget deficit—in FY 1986—represented 3.5 percent

- *An increasing consumer subsidy bill.* According to Soviet sources, budget subsidies for meat and milk products increased from 24 billion rubles in 1981 to 57 billion rubles in 1986. Housing subsidies increased from 6.9 billion rubles in 1980 to 10.4 billion rubles in 1987. In 1988, total subsidies to benefit the consumer were said to total over 90 billion rubles.
- *Rising levels of defense spending.* We estimate that defense expenditures have been increasing since 1985 by at least 3 billion rubles annually.¹
- *Unanticipated costs such as the Chernobyl' cleanup.* Last October, Finance Minister Gostev estimated the cost of the Chernobyl' accident at more than 8 billion rubles.

¹ Derived from CIA estimates of Soviet defense spending in 1982 factor cost prices, which represent minimum increases in current price defense spending levels.

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Figure 1
USSR: State Budget Revenues and Expenditures, 1983-89



Source:
Expenditures: Official Soviet data.
Revenues: Calculated from official Soviet data and CIA estimates.

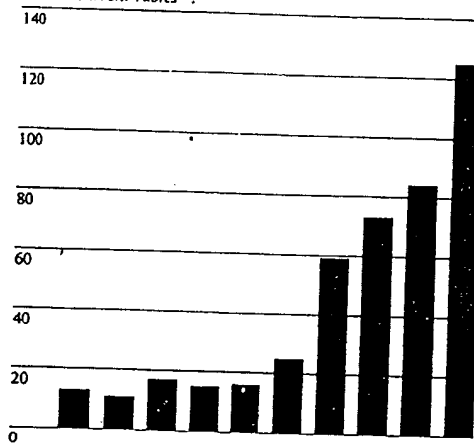
of US GNP.) The low 35-billion-ruble figure for 1989, as well as discrepancies for earlier years, is attributable to Moscow's definition of government loans from the State Bank as a revenue source. Such loans, however, are the equivalent of simply printing more money.

Since Gostev's announcement last October, prominent Soviet economists, including Oleg Bogomolov and Leonid Abalkin, have acknowledged that, in accepted world practice, the value of State Bank loans to the government represents a deficit, not a revenue. By adding 63 billion rubles—asccribed by Gostev to "resources of the statewide loan fund" to his deficit figure of 35 billion rubles, the economists arrive at a total deficit of "about 100 billion" rubles for 1989. Vyacheslav Senchagov, Deputy Minister of Finance, gave the first official recognition of the 100-billion-ruble figure in a TASS report in late February

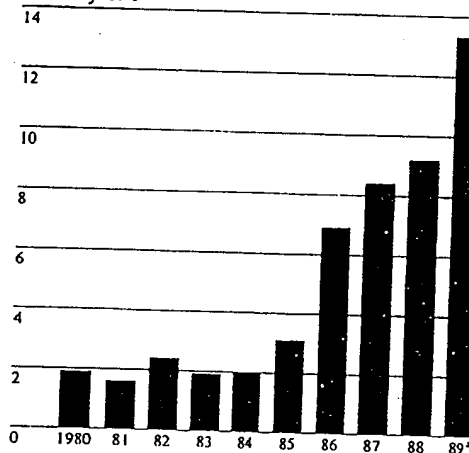
Figure 2
USSR: Estimated State Budget Deficit, 1980-89

Note scale change

Billion current rubles



Percent of GNP



* Projected: based on budget figures announced in October 1988.

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Table 1
USSR: Budget Deficit and Sources
of Finance

	Billion Current Rubles		
	1987	1988 ^a	1989 ^b
State budget			
Expenditure	431	444	495
Estimated tax revenues	358	360	369
Deficit	73	84	126
Known sources of finance of deficit			
Long-term borrowing (bond sales)	2	2	2
Short-term borrowing from the State Bank (savings receipts)	24	31	35
Residual ^c			
Implied other short-term borrowing from the State Bank	47	51	89

^a Preliminary.

^b Plan as announced in October 1988.

^c Some of this residual could represent unused funds that are turned back into the budget at the end of the year, but Soviet secrecy in this area prevents us from knowing whether this occurs on a significant scale.

The 25-billion-ruble difference between this figure and our estimate shows up, in our view, as most of a 39-billion-ruble residual block of revenue that is undefined in Gostev's accounting (see table 2). We estimate specifically that the Soviets can raise 13 billion rubles through miscellaneous taxes not defined in Gostev's accounting. We assume that the remaining 26 billion rubles will have to be covered by borrowing, most probably in the form of short-term loans from the State Bank, since the possibility that the Soviets could alternatively realize increased revenues of this magnitude from some new tax seems very unlikely.

Why Plan Increased Spending in 1989

In spite of the official announcements, the Soviet leadership is almost certainly aware that the deficit has been growing, not declining, since 1985. Moreover, Gorbachev has acknowledged that a large deficit complicates the process of restructuring the economy.

Table 2
USSR: Announced 1989 Budget Revenue

	Billion Rubles
Total revenue	458.4
Payment from profits	121.2
Turnover tax	104.1
Revenue from foreign economic activity	60.0
Deductions for social insurance	31.4
Taxes and receipts from the population	39.4
Resources of the statewide loan fund	63.4
Subtotal	419.5
Residual	38.9

Source: Soviet Finance Minister Gostev's speech to the Supreme Soviet, 27 October 1988.

He nevertheless adopted a budget plan that dramatically increases the deficit in 1989. We believe this reflects the political difficulty of controlling spending as the leadership attempts to shift a greater share of the national output toward the consumer.

While we do not know precisely the sequence of events, Soviet and Western reporting strongly suggest that, during 1988, Gorbachev increasingly became convinced of the necessity to accelerate his expensive consumer programs. Consumers have come to feel that they have benefited little from *perestroika* and that, if anything, they are worse off since Gorbachev took power [

While food supplies remain the chief source of frustration—even the 1988 plan fulfillment report noted a "strained" food availability situation—anger is growing over long waiting lists for housing as well as the absence of toothpaste, detergent, and other nonperishables in state stores. Compounding the problem, elements of the economic reform have sometimes worked against the consumer's sense of well-being.

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For example, as light industry enterprises have attempted to increase the value of their sales in line with the new principles of self-financing, low-priced clothing has been disappearing from the market, causing particular hardships for working-class families.

We assume, moreover, that Gorbachev had serious problems convincing some of his ministers to accept cuts in their budgets that would allow both increased funding of consumer measures and a reduction in the state budget deficit. Meeting substantial resistance, he may have then decided that the needs of the consumer sector were simply too great to be ignored, even if they could not be accommodated within present revenues. In effect, he decided to attempt to spend his priorities into existence. Indeed, the budget planning process, by not requiring planned expenditures to be covered by revenues, lends itself to this approach. In a November 1988 newspaper interview, Leonid Abalkin, Director of the Academy of Sciences Institute of Economics, said, "We cannot bring ourselves to restrain the growth of budget expenditure. This is how we draw up the plan: First we set spending levels, then try to find the income to go with them. Hence the state budget deficit."

Although Gorbachev may be counting on defense cuts to provide significant relief down the road, the severe inflationary consequences that are almost certain to follow this year's deficit make any postponement of spending reductions a risky strategy. Gorbachev has shown himself willing to accept reasonable risks in other situations, but it is possible that he has underestimated them in this case. Conceivably he has assumed that the Soviets' system of administered prices would provide a sufficient lid on inflationary pressures, but their economic history of the 1930s shows clearly that the system is not immune to runaway inflation (see inset).

Can Moscow Ever Live Within Its Means?

Boosting Revenues

In his October 1988 discussion of the budget plan for 1989, the Finance Minister offered few effective measures to deal with the deficit. He implored all users of state funds to reduce spending and called for

Soviet Inflation in the 1930s

During the 1930s the Soviet economy was beset by severe and persistent inflation. In one year in the early 1930s, consumer goods prices in state and cooperative stores doubled, and within a similar period collective farm market prices rose 500 percent. Between 1928 and 1940, wages in the economy rose almost sixfold, consumer goods prices increased about twelvefold in state and cooperative stores and more than twentyfold in collective farm markets, and prices of basic industrial goods rose about 250 percent.

Several factors combined to cause this rampant inflation over the course of the decade. Output of consumer goods declined as the industrialization drive of the early 1930s shifted production in favor of producer goods. At the same time, an inflationary monetary policy injected large amounts of cash into circulation. Short-term State Bank loans outstanding increased from about 4 billion rubles in 1930 to 55 billion rubles in 1941. As a result, currency in circulation—representing wage payments almost exclusively—increased from about 3 billion rubles to 16 billion rubles in the same period.

Boosted by rising average wages and employment, money incomes rose substantially while the supply of consumer goods was declining. Attempts to deal with the resulting inflation through a combination of increased turnover taxes, rationing, and a complex system of multiple prices designed to maintain labor incentives were essentially unsuccessful. Consumer demand continued to exceed supply throughout the 1930s. With the outbreak of World War II, inflationary pressures became much greater, but the imposition of a wide range of direct controls constrained labor mobility and slowed the rise in state consumer goods prices. The excess purchasing power accumulated during the war was eliminated through the discriminatory 1947 currency exchange.

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lotteries, insurance programs, and local bond issues to raise revenues. Although he was optimistic about increasing turnover tax receipts from the planned step-up in production of clothing and household appliances, a more likely source in the short run would be a relaxation of constraints on alcohol sales, which also would serve to mollify consumers upset with the antialcohol program. Indeed, the production of wine, beer, and cognac increased in 1988, and sales hours at state liquor stores were extended starting last summer. Recently the Politburo took the unprecedented step of approving the sale of state-owned housing to individuals to raise revenues and soak up some of the excess purchasing power in private hands. Another option to augment state income would be to greatly increase imports of highly taxed consumer durables and other luxury goods. f

We do not have enough information about Soviet plans to estimate how much revenue might be raised by these measures over the next couple of years, but the amounts will probably be small relative to the current deficit. Moscow recognizes that reducing spending is the key to bringing the deficit down—not increased revenues.

Cutting Spending

Official recognition of the need to slash government expenditures was underscored in TV coverage of a 14 January Council of Ministers meeting. During this highly charged meeting, Chairman Ryzhkov wondered aloud why none of the ministers seemed worried about the budget deficit and also indicated that an "emergency" program was being formulated to address the deficit problem. At the same meeting, Gosplan Chairman Maslyukov said that state expenditures would have to be cut by:

- Reducing capital investment.
- Cutting defense expenditures.
- Cutting subsidies to loss-making enterprises by 30 percent in 1989, or by about 3 billion rubles, and virtually eliminating them in 1990—a savings of 11 billion rubles.

Maslyukov also indicated that the option of increasing highly taxed consumer goods imports by reducing imports of other goods would be examined.

Bigger Is No Longer Better

Over the past year, Soviet officials and the media have targeted waste, inefficiency, and ecological damage involved in large-scale investment projects such as dams, canals for water diversion, and huge hydroelectric installations. Moves have been made to close down a number of major projects, including the Dnepr-Bug hydraulic complex, the Volga-Chogray canal project, and a large hydroelectric power complex on the Yenisey River in northern Siberia. More recently, the criticism has extended to questioning whether the Baikal-Amur railway (the BAM)—a centerpiece investment project of the past decade—should be completed and maintained. These huge projects are excessively costly, have run on for years, and are out of step with the regime's current investment priorities of improving the economy's technology base and orienting production toward the consumer. f

There have been recent indications that Moscow is, in fact, taking a harder look at investment expenditures. Giant, centrally financed construction projects are increasingly out of favor as investment priorities are shifted toward retooling of existing enterprises and toward more locally directed and financed projects. The Soviet media have already announced the halt of several major construction projects (see inset).

Gorbachev's announcement to the Trilateral Commission in January of a 14.2-percent reduction in defense spending by 1991 raises the possibility of savings in a hitherto sacrosanct area of the state budget. We estimate the annual savings would amount to 20-25 billion current rubles, equivalent to just 4 to 5 percent of total state spending or 15 to 20 percent of the potential 1989 deficit.

The glimpses of the road ahead, nevertheless, suggest that spending pressures over the next few years will remain high. Massive investment initiatives are

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planned, such as the programs to spend a total of 35 billion rubles on roadbuilding, 27 billion rubles on light industry, and 77 billion rubles on food processing and storage during the next seven years. According to Igor Belousov, Military-Industrial Commission head and Council of Ministers Deputy Chairman, the plans for modernizing the food-processing industry include the retooling of 38,000 enterprises and the construction of 29,000 new ones by 1995. Moreover, Gorbachev has promised increased spending for medical, educational, and other social programs.

Gorbachev's political and economic reforms also are likely to make it more difficult to rein in spending. One of the key elements of his political reforms announced last June, for example, is a devolution of authority to republic and local legislatures to raise and use funds. If these officials come to have a greater say in the investment area, the center will have less influence in controlling overall spending levels. This seems clearly illustrated in the final decision to send more resources to the agricultural processing sectors in 1989, following a review by a legislative commission, despite Gosplan's initial attempt to cut back investment in the agroindustrial complex. Similarly, Gorbachev's economic reforms call for enterprises to retain more of their profits and use them for investment. According to Gosplan Deputy Chairman Leonard Vid, enterprises have increased their share of financing of state capital investment from 3.2 percent in 1986 to 38.4 percent in 1988. Leaving more resources in the hands of enterprises to make their own investment decisions clearly will weaken central control.

Implications for the Economy

The budget deficit—and the inflationary consequences—is in reality a manifestation of the failure of *perestroika*. For example, the huge injection of investment spending into the economy that began in 1986 has not been accompanied by a corresponding increase in productive capacity. Growth of additions to capacity fell from about 6 percent in 1986 and 1987 to less than 1 percent in 1988. Retooling and reconstruction of existing enterprises have not replaced new construction as the vehicle for absorbing

investment funds, and the amount of unfinished construction has increased, not decreased. As the investment spending has worked its way through the economy, enormous sums of money have flowed to enterprises and into the hands of the population in the form of wages. But the capacity to produce the industrial and consumer goods that could absorb these rubles has not materialized.

Moreover, budget expenditures have been an increasingly important tool for ensuring "social harmony." According to a *Kommunist* article by Soviet economist Konstantin Kagalovskiy, the financial system has gradually replaced propaganda and coercive measures as the main means of maintaining the "socioeconomic balance." The financial system acts as a kind of shock absorber for all enterprises, alleviating the consequences of adverse changes from circumstances over which enterprises have no control. For example, if an enterprise becomes unprofitable, as a rule, the wages of its personnel do not decline and it continues to receive funds for its polyclinic, kindergartens, and housing, according to Kagalovskiy. He argues that this is done to deter "nontraditional" forms of behavior—sharp increases in personnel turnover, complaints to authorities, work slowdowns, and strikes—or even social disintegration. Reversing this policy by, for example, closing down insolvent enterprises obviously must be done carefully.

The Cost of Continued Inaction

Moscow faces continued large budget deficits over the next few years if current spending and revenue programs are not drastically changed. Inflation probably will continue to surge—perhaps to a rate of 10 percent or more (see inset). Many Soviet consumers already have been hit hard by the extraordinary expansion of purchasing power over the last few years. Growing inflation will increase the redistribution of income from pensioners and others on fixed incomes to those whose incomes will rise with inflation, such as members of cooperatives, private-plot farmers, second-economy operators, and state workers whose skills are in demand. Consumer complaints are sure to intensify as will the tendency for many Soviet citizens to blame their situation on *perestroika* and Gorbachev.

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Inflationary Pressure, Soviet Style

The consequences of excess aggregate demand are different in the Soviet economy from those in Western economies. Consumers face rising prices where prices are uncontrolled—in collective farm markets and private cooperatives. In the state sector, where prices are controlled, manufacturers are able to substitute higher priced for lower priced items. When these responses are insufficient to soak up excess purchasing power, shortages worsen and consumers confront rationing (by coupon and by queue) and increase their savings.

Indications of all these phenomena were in evidence last year. For example:

- By mid-1988, eight of the USSR's 15 republics were forced to initiate rationing schemes to distribute scarce foods such as meat, butter, and sugar more equitably.*
- Average meat prices in state and cooperative stores in 1988 increased 4 percent over those of 1987, potato prices increased 7 percent, and leather footwear and clothing prices increased 8 and 10 percent, respectively.*

- Additions to savings bank deposits during the year totaled 31 billion rubles, a 6.5-billion-ruble increase over additions in 1987, the largest annual increase in at least two decades.*

The absence of free markets for industrial goods and services, as well as a lack of information concerning the extent of shortages, make it very hard to determine whether inflationary pressures have risen in the largely noncash producer goods and services-sector of the Soviet economy. Results from [] research on inflation in official Soviet investment statistics strongly suggest the presence of significant inflationary tendencies in the investment sector. Anecdotal evidence also supports this judgment. For example, during a recent capital goods auction shown on Moscow television, enterprise representatives were willing to pay enormous prices for needed items of equipment—up to 17 times the established price in the case of one truck sale.

The leadership almost certainly realizes that over and above the consequences for consumers and of potential unrest, a burgeoning deficit entails follow-on economic and political costs. The eroding value of the ruble seriously threatens some of Moscow's most important economic priorities:

- The drive to improve labor productivity is being undermined. Inflation results in stagnant or falling real wages for workers on fixed state salary and wage scales, with consequent damage to morale and work effort.*
- Retail price reform—considered by Soviet leaders and economists to be the most important economic reform of all—is being postponed because of concern that decontrolled prices would spiral upward.¹*

- Gorbachev's goal of increasing work incentives, while maintaining an effective safety net, is being contravened. While second-economy workers and state workers, who have ensured access to food and other goods in short supply, benefit in real terms, pensioners and others on fixed incomes lose out. (u)*

The impact on consumer markets of the increasing financial imbalance has become readily apparent, and the leadership undoubtedly is feeling pressure to act. Gorbachev's options for bringing the situation under control are limited, however, and in general there will be increased austerity for some claimants to the state's resource.

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This may explain reports of disarray in Moscow's economic policy making circles. ^{gold} for example, that there was no consensus in the leadership about how to deal with the "deepening economic crisis." And clearly the leadership wants to avoid any measures that would further exacerbate pressure on the "social contract." Nevertheless, Moscow now appears to be moving closer to taking a series of actions designed to alleviate its financial problems.

Action Coming?

The leadership has dealt with the financial instability resulting from the ballooning deficit on an ad hoc basis, compounding the already difficult job of implementing economic reform. Reform schedules have been disrupted and short-term administrative remedies have been applied that run counter to longer range goals. For example:

- The government has felt compelled to increase producers' subsidies on goods for children and senior citizens in an effort to check manufacturers' steps to replace production of low-priced clothing and footwear with more profitable expensive items. Budgetary subsidies already amount to some 90 billion rubles annually, and this action to increase them will only add to the mounting inflationary pressures.
- A government decree issued in early February prohibits excessive increases in contractual prices—set by agreement between suppliers and purchasers—on producer and technical goods. This restriction on contractual prices reduces the limited freedom that enterprises had been granted in this area and is another indication of backtracking on economic reforms.
- A late February decree of the Supreme Soviet presidium encouraged the imposition of much higher tax rates on income from cooperatives than those currently in effect and gave broad discretion to republic governments in setting new rates. Higher tax rates on cooperatives will tend to discourage the favored private sector under *perestroyka*.

More comprehensive measures are probably in the offing. According to the new weekly government newspaper, *Pravitel'stvennyy vestnik*, a Council of

Ministers' committee has prepared a proposal for reducing the state budget deficit and, in general, improving the financial health of the country:

- State investment expenditures are to be reduced by 6-7 billion rubles in 1989 through cuts in large regional long-term development projects and land reclamation projects. After 1990, expenditures will be further reduced by switching to greater financing of investment by the enterprises through their own funds and interest-bearing bank loans.
- Retail trade turnover is to increase by 25 billion rubles over sales in 1988 and 8 billion more than called for in the 1989 plan in order to absorb surplus money in the population and increase state revenues from turnover taxes. Some of the increase is to come from conversion of military production facilities to civilian output and from increased imports of consumer goods at the expense of capital goods.
- Enterprises are to make substantial cuts in their inventories, which currently amount to 470 billion rubles, with the excess inventories used to increase output or sold to other enterprises or directly to the population. To enforce these cuts, the committee is proposing that a surcharge of up to 15 percent be levied on above-norm inventories as of 1 April 1989.

The announced 14.2-percent cut in military expenditures, while not mentioned specifically, is no doubt also included in these efforts to reduce the state budget deficit.

In late March 1989, Finance Minister Gostev announced that these cuts and other measures would reduce the 1989 deficit by 30 billion rubles, or 24 percent of our projected deficit for 1989. While they are steps in the right direction, they are too little and too late to defuse the inflationary pressures now building in the Soviet economy. Even if reduced by 30 billion rubles, the deficit for 1989 would equal an estimated 96 billion rubles. Moreover, the upward revision in consumer goods production is dwarfed by the vast overhang of purchasing power represented by Soviet savings deposits (see inset).

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*Dealing With the Purchasing Power "Overhang":
A Currency Reform?*

There have been a number of reports that currency reform is under consideration by the leadership, although the government has strenuously denied that a confiscatory reform of the ruble will be put into effect. The 300 billion rubles in savings deposits, as well as cash hoards, are a major source of liquidity in the Soviet economy. Because increased inflation means that savings are losing value, Soviet citizens have an ever greater incentive to convert their savings into goods, worsening inflationary pressures. The huge ruble overhang in the hands of the population makes the leadership's attempt to correct the imbalance between money incomes and goods supply through increased consumer goods production patently unrealistic.

A drastic reform of the currency was carried out in 1947 by a decree that established different rates of exchange for converting old ruble currency to new rubles and was directed primarily at reducing peasants' cash holdings to a noninflationary level. Cash holders were treated least favorably, receiving one new ruble for 10 old rubles. On savings bank deposits over 10,000 rubles, one new ruble was exchanged for two old ones; on deposits from 3,000 to 10,000 rubles, two new rubles were given for three old ones; and on deposits up to 3,000 rubles, the exchange was on a 1-for-1 basis. State bonds were converted at an exchange rate of 1 to 3 and thus lost two-thirds of their value.

The currency reform was successful in wiping out a large part of the repressed inflation that had developed during the war. Subsequent to the reform,

reductions in prices of consumer goods sold in state stores were followed by lower prices in collective farm markets as well.

A currency exchange today would be a one-time remedy to wipe out the overhang of accumulated excess purchasing power. If such a step were being planned, it is something the authorities would want to keep secret until it was a fait accompli to avoid runs on savings banks. Rumors that such an exchange was imminent have been reported over the last couple of years and probably have contributed to spending pressures.

Such a measure amounts to state confiscation of private wealth. The regime could attempt to justify it by arguing that it was targeted toward second-economy "speculators" and other profiteers—indeed, 3 percent of Soviet citizens reportedly hold 50 percent of Soviet savings. At a minimum, however, a reform would undermine Gorbachev's efforts to encourage personal initiative—a crucial underpinning of perestroika—and antagonize the most productive elements of the population. Because even the less advantaged reportedly maintain cash hoards, the net effect probably would be to increase popular disaffection with Gorbachev. For these reasons we believe government denials are since.

Recent official statements reflect a much higher level of awareness by the leadership of the connection between the deteriorating financial situation and the prospects for economic improvement than did the highly inflationary 1989 economic plan and budget announced just a few months ago. While Moscow now appears to have a clearer sense of priority about the financial problem, Gorbachev has only limited maneuvering room over the short term to restore financial stability to the economy; keep his programs for

consumer welfare, economic restructuring, and reform on track; and minimize political disaffection with his regime. As he maneuvers, he must weigh the political and social costs of the "cure" against the economic costs of the "disease."

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