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Why Perestroika?

The Soviet experiment with socialism has had uneven results. On the one hand, the Soviet Union has fulfilled certain basic objectives set out early in this century: it is a major world power and some basic social needs are being met. On the other hand, lagging Soviet economic performance presents major difficulties. Shortages are endemic. Available products are of poor quality and design, creating large inventories of unwanted goods. The lack of amenities and restrictions on free speech have created a passive and increasingly unproductive work force that is little motivated by wages that can purchase only a limited quantity and selection of goods.

In response to these developments, the Soviet Union has launched a wide-ranging program of economic restructuring, known as *perestroika*. The bulk of the program was adopted in June 1987, and is to be completed by January 1, 1991, in time for the implementation of the Thirteenth Five-Year Plan. This *Letter* reviews some of the causes of poor Soviet economic performance and the thrust of the reforms.

The economy

Following comparatively robust growth in the second half of the 1960s, Soviet economic performance began deteriorating sharply in the 1970s, with economic growth consistently falling below target. From 1981 to 1985, estimated annual GNP growth of two percent was less than half the peak of five percent in the period from 1966 to 1970. Indicators of lagging performance have extended across the major economic sectors. Growth of industrial output fell even more sharply than did GNP growth, and chronic difficulties beset agricultural production.

Underlying the slowdown in growth has been a decline in productivity growth. The annual growth in labor productivity fell from 6.2 percent in the period from 1966 to 1978 to three percent in the 1981 to 1984 period. Capital productivity appears to have *declined* at a 2.8 percent annual rate during this latter period. As a result, total factor productivity growth fell from a peak annual rate of 3.2 percent in the earlier period to 1.1 percent in the later period.

Shortages of labor and intermediate products have impaired production. In addition, the tendency for enterprises and ministries to undertake large new projects has exacerbated existing capacity constraints. The hundreds of thousands of construction projects now in place have reportedly lengthened the average time required to bring new productive facilities on line to 20 years in several sectors. In the 1960s, in contrast, the gestation period for investment projects was seven to eight years from design to full capacity operation, still about twice the average for other industrial countries.

Sluggish economic performance has contributed to government budget deficits (financed by loans from the State Bank) over the past ten years. Soviet authorities recently estimated that the government deficit will reach $56 billion in 1989, or about four percent of GNP. In the West, estimates of the Soviet budget deficit actually run as high as $90 billion. Bailouts of loss-ridden public enterprises are largely to blame for these deficits, although the falling price of oil on world markets and the cost of cleaning up after the Chernobyl nuclear plant disaster also have had a major impact on government finances since 1985.

Economic structure

Two structural factors account for the Soviet Union's poor economic performance since the late 1960s. The first is the overwhelming burden of centrally managing a complex economy. It is estimated that the State Planning Committee and the State Committee for Material Supply must plan the supply and distribution of 25,000 products. At the same time, the State Price Committee considers approximately 200,000 price proposals per year, and 500,000 other price proposals are handled by ministries or other authorities.

The second factor is the perverse incentives the system creates. Prices and subsidies designed to provide absolute job security and prevent bankruptcies ratify economic inefficiency. Performance targets are based on currently achieved levels, creating incentives to hide true production capabilities. Moreover, since enterprises are required to focus primarily on output targets, profitability, productivity, and quality frequently suffer. The focus on output also discourages innovation, as retraining workers and retooling lower output in the short run. Although the government has introduced additional targets for profits, total wage bills, productivity, quality, and R&D expenditure, these targets generally cannot be fulfilled simultaneously. In the final analysis, successful managers cannot concentrate on developing good products, but instead must spend their energies developing good ties to ministerial bureaucracies to minimize penalties for targets they fail to fulfill.

Efficiency is further impaired by the direct interference of ministerial bureaucracies in the operations of enterprises and by the periodic demands of local authorities for labor or capital resources from enterprises operating in their jurisdictions.

Economic reforms

In an effort to address these structural problems, an economic reform program was adopted in 1987. The program involves enterprise reform, price reform, bureaucracy reform, the legalization of private enterprise, and a number of related measures designed to improve economic performance.

Enterprise reform is designed to increase both the autonomy and the financial self-sufficiency of enterprises. Enterprises may now select their customers and suppliers and decide the output and input mix, the structure of wages and bonuses, and the magnitude of capital investments. Top management of enterprises is to be elected for five years by a workers' conference in multicandidate elections confirmed by higher organs.

To increase efficiency, enterprises will have to earn the funds to cover labor, material costs, and supplies and still have an investable surplus (to be supplemented by loans in the case of large projects). Provisions for identifying insolvent enterprises and beginning bankruptcy proceedings have now been established.

Price reform dictates that by 1991, prices largely will be negotiated between buyers and sellers, following rules established by the State Price Committee. The latter will set the prices of a few key products (raw materials, fuels, and scarce "nationally important" products). In the meantime, a price index is being developed.

Under *bureaucracy reform,* detailed planning is to be abandoned, and interference from government ministries is forbidden. As a result, the staff of government ministries is likely to be pared down, and ministries may be merged into "complexes" covering machine building, transportation, construction, fuel and energy, metallurgy, chemicals and timber, foreign economic relations, consumer goods, and agro-industry.

However, central government control will not be eliminated altogether. Non-binding guidance plans, reflecting desired productive activity and efficiency criteria, will be sent to enterprises as part of each five-year planning cycle. In addition, the State Planning Committee, ministries, and republic authorities can issue orders for the fulfillment of the state's highest priority needs (defense, for example) and for central government investment projects. Procurement will in some cases be issued competitively, with guarantees for the supply of key inputs.

Private enterprise was legalized in May 1987, to encourage the production of consumer goods. Enterprises may be formed by individuals or cooperatives and are licensed by the state and subject to tax or license fees. Workers employed in state industry can only engage in private activity in their off-hours, but their immediate family members over 16 years of age, as well as students, housewives, and pensioners can work full-time in such businesses. Some state assistance is offered in finding facilities for private operations.

Other measures

A key element of the effort to improve economic performance is a major investment program designed to modernize Soviet industry to levels comparable to the West. A plan to freeze up to 40 percent of the ongoing construction projects may free some resources for this machine building and metalworking investment program.

Financing for the program may also be obtained by borrowing from abroad. The Soviet Union's net external indebtedness totalled an estimated \$23 billion in 1986. Late in 1988, Western banks approved an additional \$6 billion in long-term lines of credit to the Soviet Union. Recent steps to allow joint ventures involving minority participation by foreign investors may also provide capital and improve technology and management.

Perhaps the best-known measure associated with *perestroika* is the *glasnost* ("openness") campaign, which encourages citizens to criticize all but the top leadership through the press, television call-in shows, and town hall meetings. A democratization program is also in place, and elections have been introduced at the local level. Both measures are designed to encourage civic consciousness, as well as to highlight inefficiency or corruption.

Prospects

Perestroika represents a major breakthrough, because Soviet leaders now appear to recognize the limitations of highly-centralized economic planning. Four previous efforts at reform since Stalin's time have failed, in large measure because accountability for production targets remained highly centralized, encouraging interference in enterprise operations by higher authorities. In contrast to previous episodes, the present reform abandons detailed planning and transfers accountability and a great deal of authority to enterprises.

Nevertheless, the risk of repeating previous failures remains. One problem is that it is not clear how much authority really will be transferred to enterprises. The new arrangements for "guidance planning" may provide an avenue for renewed high-level interference in enterprise activities. The government may also preempt the new freedom of enterprises to determine output if it places large orders with enterprises to meet "priority" needs.

Social pressures may also limit the extent of the reform or its effectiveness. For example, efforts to increase productivity through financial incentives and the legalization of private enterprises may lead to inequalities in income distribution that are likely to be resisted by hardliners.

Another crucial problem is that price reform is currently the last, rather than the first, component of the reform program. One reason for the delay is the fear that, as in China, price reform may lead to accelerating inflation due to pentup excess demand. Inflation in the Soviet Union is unofficially estimated to be at six to eight percent and rising. Also, Soviet policy makers may not fully recognize the importance of a functioning price mechanism. Consequently, prices will not serve as signals for correcting imbalances in supply and demand or for motivating newly autonomous enterprises to operate more efficiently until 1990. Even after 1990, enterprises may remain sheltered from domestic and foreign competition to some extent. Unless the present system of allocating resources by fiat is replaced by a functioning price system, *perestroika* may not succeed in fulfilling *any* of its economic objectives.

Many observers, in fact, doubt the feasibility of the wide-ranging reforms encompassed by *perestroika,* as they require the bureaucracy to surrender power and changes to be made in values and attitudes fostered for over half a century. However, a significant number of Soviet leaders appear to recognize that the economic problems of the Soviet Union will not be solved without fundamental changes. Perhaps the broad scope of *perestroika,* and the magnitude of the stakes involved, are the best guarantee that it will achieve some success.

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