MEMORANDUM FOR:

This is a good review of the Soviet economy, very much along the lines of our own. What is interesting is that Business Week has chosen to make it a cover story.

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THE STALLED SOVIET ECONOMY

Bogged down by planning

Like a sputtering 1950s-model engine, the Soviet economy is slowing to a crawl, braked by the inefficiency and rigidity of its outmoded central planning system.

Deep trouble is brewing in Soviet agriculture: On Oct. 1, U. S. officials revealed that the Kremlin plans to buy up to 23 million tons of grain from the U. S. in the coming year, part of an estimated 40 million tons worth $6 billion that the Soviets will need to cover a now-chronic shortfall in harvests from Soviet state and collective farms (chart, page 73). For several years, Russians have been standing in lengthening queues to buy scarce and rationed food, which accounts for 50% to 70% of the average Soviet family budget. The shortages underline the inability of the Soviet leadership, for the first time since World War II, to claim that it is raising Soviet living standards.

The economic shortcomings are closely linked to a deepening sense of alienation among many in the Soviet Union's heterogeneous population of 260 million. The alienation is reflected in widespread corruption and malingering by farm and factory workers, part of a malaise that U. S. Secretary of State Alexander M. Haig Jr. calls "spiritual exhaustion." One index of eroding morale is an epidemic of alcoholism so severe that it is shortening Soviet life spans. Says a young Muscovite: "Loafing and drinking are the only acceptable forms of protest."

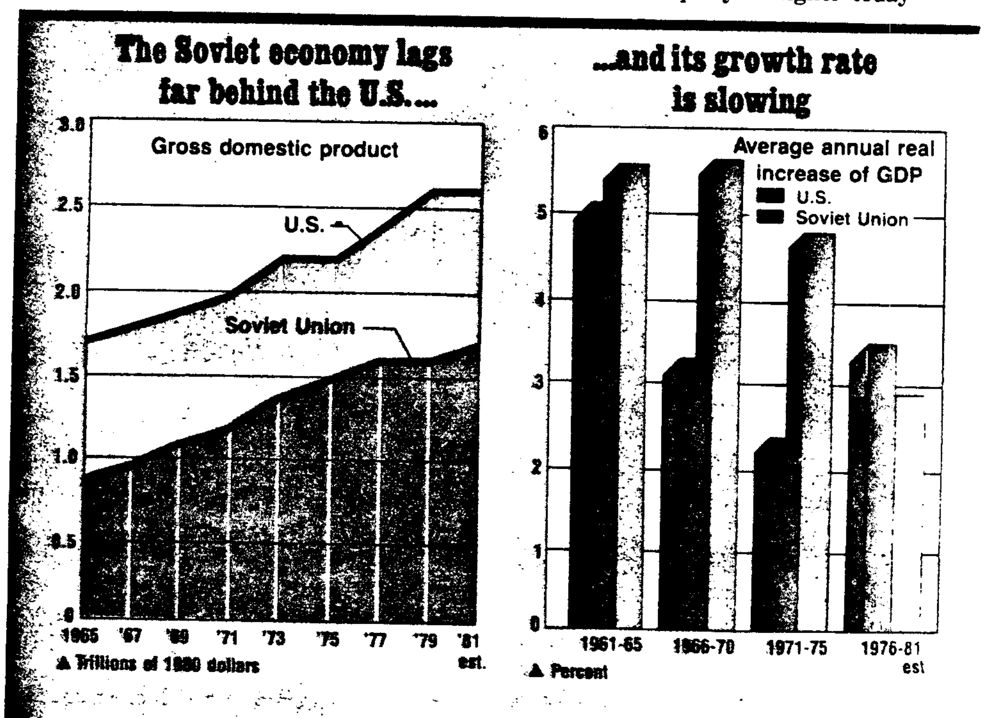
There is scant chance that such discontent will crystalize into active opposition to the Communist Party's tight political control or into any challenge to the power and status of the 17 million party members who enjoy the perquisites—from cars and dachas to trips abroad—of a privileged elite. But in the Soviets' global rivalry with the U. S., the poor economic performance raises an ominous threat for the Kremlin's leaders: Eventually, it could undermine the Soviet Union's capacity to sustain the military machine and the global commitments that underpin its role as a superpower. Up to now, although the Soviet economy is less than two-thirds as large as that of the U. S. (chart), the Kremlin has matched or even outspent the U. S. militarily by pouring 12% to 14% of its gross national product into arms, compared with 5% for the U. S. in recent years. But the economic slowdown will intensify the Kremlin's guns-vs.-butter dilemma: The military buildup competes for scarce resources against urgent consumers' demands and against capital investment that is crucial to economic growth.

Risks to the U. S.

Paradoxically, the economic slippage and other Soviet troubles, ranging from China's hostility to "ideological sterility," could also render the Soviet Union more dangerous to the U. S., Haig argues. Kremlin leaders could be tempted to lash out—to grab control of Persian Gulf oil, for example—in an attempt to tilt the global strategic balance in their favor before they fall hopelessly behind the U. S. But in the jockeying to succeed the 74-year-old Leonid Brezhnev and other aging Soviet hierarchs, the Kremlin's policy debate will also focus on internal economic reform. "There will be leaders who will fight for power in the coming succession under the slogan, 'Let's get the country moving again,'" predicts Seweryn Bialer, director of Columbia University's Research Institute on International Change, "and there will be leaders who will try to engage in foreign adventures."

Right now, the Kremlin is weighing the heavy risks and costs—in bloodshed, resources, and heightened global tensions—of intervening in Poland to prop up the floundering Polish Communist leadership. If it does not intervene, Moscow faces the costs of providing aid to the collapsing Polish economy. Other burdens for the leader of a major political and ideological bloc include billions of dollars annually that the Soviets spend to maintain influence over a network of satellites and aid recipients, mainly through price concessions on trade in oil and sugar with East Europe and Cuba.

Such huge demands will severely strain Soviet resources if the economy continues to decelerate, and the Kremlin is clearly worried. Recently, insider briefings for the Soviet intelligentsia and party members have warned of hard times that could last 15 years or more. And top officials, led by Party Secretary Brezhnev, are displaying their anxiety publicly with repeated denunciations of mismanagement and production shortfalls. "The Soviet leaders' consciousness of economic inadequacy is higher today



MacNelly/Chicago Tribune—NYNS

than it ever was in their post-Stalin history," says Bialer.

Part of that consciousness is the awareness of having crossed an important psychological, as well as economic, watershed. During most of the post-World War II period, the Soviet was gaining economically on the U. S., a performance that prompted former Party Secretary Nikita Khrushchev to boast, in 1959, that the Soviets would "bury" the U. S. In the late 1960s, Soviet GNP expanded an average 5.7% annually against 3.3% for the U. S. But over the past six years, Soviet growth averaged only 2.9% compared with 3.5% for the U. S. (chart, page 72), and it may fall as low as 2% this year.

The economy's fundamental problem, the central planning system itself, will not be altered, though. The Communist Party's political control would be undermined by steps that would diffuse economic decision-making more widely and unleash powerful market forces. The system, based on "commands" from central planners who are not responsive to market forces but to goals decided by party leaders, worked best when the Soviet economy was in an early industrial stage. But the system is increasingly unable to cope with the complexities of a modern economy because it lacks the market price and profit criteria that are needed to allocate resources efficiently and maximize returns on investment.

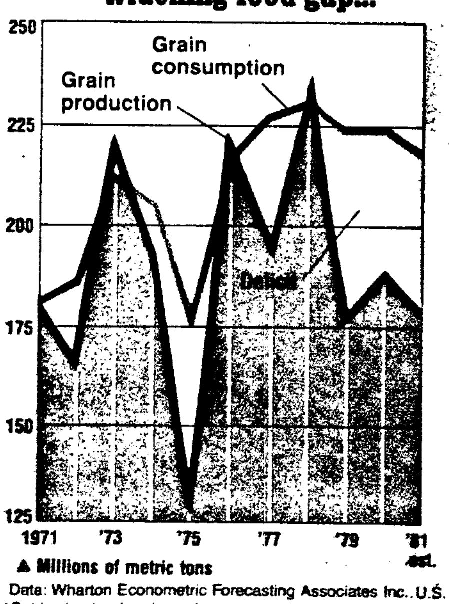
Productivity is lowered further by the virtual taboo in the Soviet Union, as in most Communist countries, against firing or laying off workers. "Today in the Soviet Union no one is working hard because they are neither ideologically motivated as they were at times, certainly during the early industrial era, nor are they terrorized into working hard as they were under Stalin," says Zbigniew Brzezinski, foreign policy adviser to former President Carter. "In our system there are both incentives and penalties—if you don't work hard, you get fired after a while. In the Soviet system, there aren't. The Soviet worker probably feels more secure than the average American worker, but also far more indifferent."

Since Joseph Stalin's time, the Kremlin has tinkered with reforms to make the system work better. But unlike the Hungarians, who have moved toward market pricing and more decentralized management, the Soviets still shrink from changes that would erode the concept of detailed central planning. The leaders who follow Brezhnev will probably share that reluctance. "The new generation is not going to be a young generation," Brzezinski predicts. "The successors to Brezhnev and company are likely to be people in their mid-sixties, themselves the products of prolonged Communist bureaucratic training."

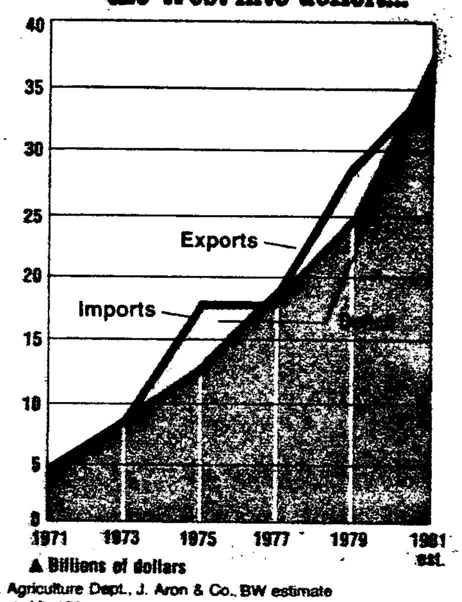
One reform experiment, launched by former Premier Aleksei Kosygin in 1967, aimed at trimming bloated payrolls and raising productivity in the Shchekino chemical complex. It did this by establishing wage funds that the enterprise could keep at the same level even if it reduced its total work force, using the money saved to raise the pay of managers and workers. Bureaucrats stifled the experiment, though, and it has not been widely adopted. Initially, Shchekino trimmed 1,000 workers from its payroll and doubled production, but the Ministry of the Chemical Industry quickly curbed managers' flexibility. "We seem to distrust our managers," complains economist Abel B. Aganbegyan, editor of a leading management journal. "They are not trusted to make even the most trivial decisions."

Another reform, in the early 1970s, set up "production associations" that dumped related enterprises under the same management and included re-

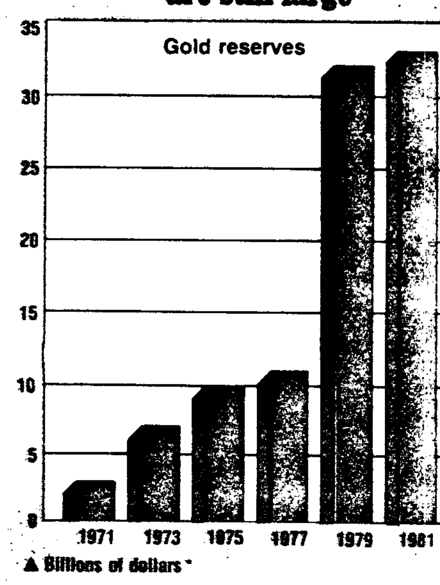
Grain imports fill a widening food gap...



...and push trade with the West into deficit...



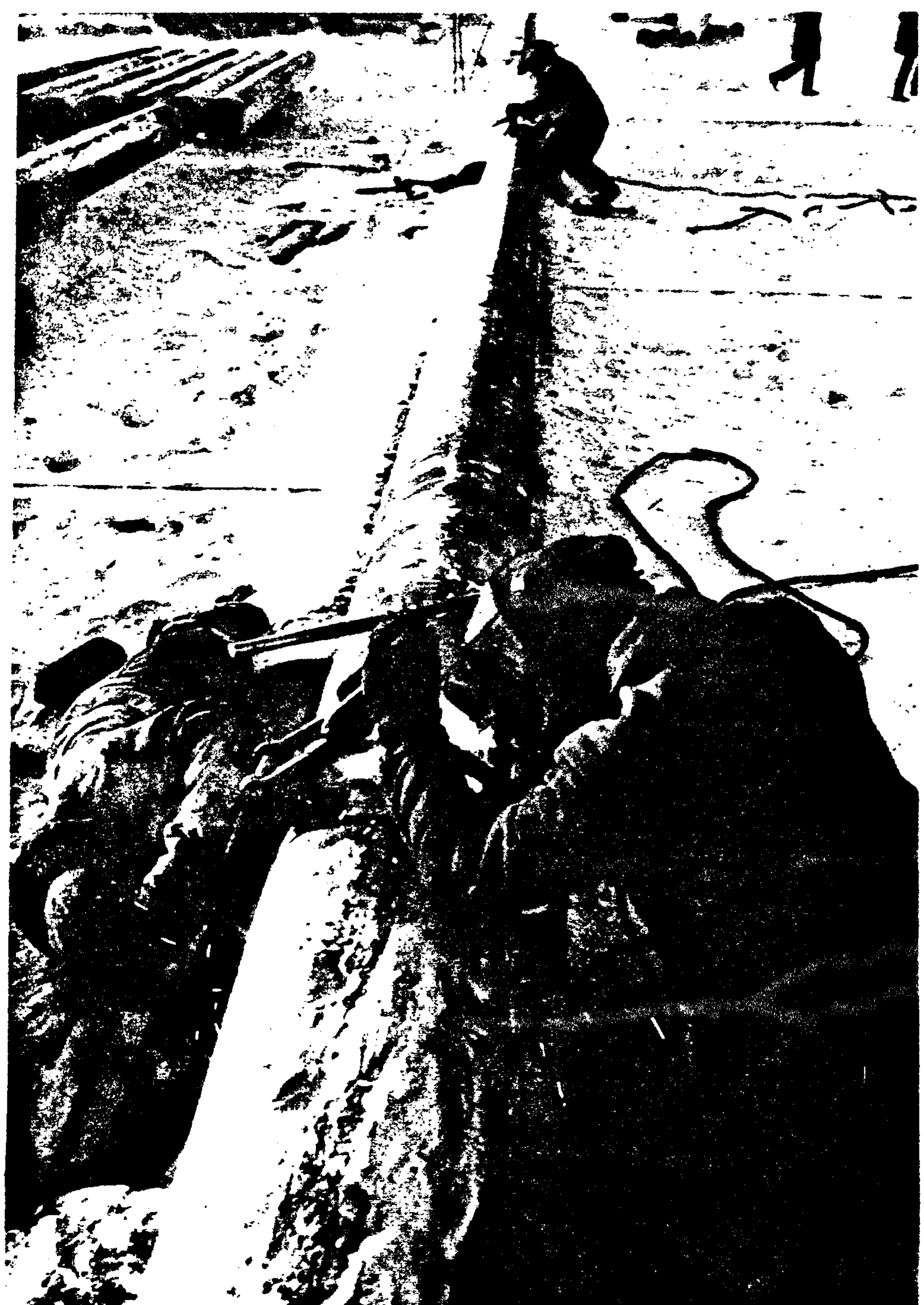
...but gold reserves are still large



Data: Wharton Econometric Forecasting Associates Inc., U.S. Agriculture Dept., J. Aron & Co., BW estimate
*Gold valued at London price at yearend 1971-79 and on Sept. 18, 1981

Derrick Langshaw BW

Bryson/Photo Researchers



Sochurek/Woodfin Camp

search institutes, in some cases, in hopes of speeding innovation. "The associations achieve some management efficiency," says Daniel Bond, an economist at Wharton Econometric Forecasting Associates Inc. "But they don't give Russians any more incentive to put their productive energies to work, and that is the basic problem in the system." The reluctance of cautious managers and bureaucrats to take risks with new products and processes has also dropped the Soviet Union permanently behind the West in most civilian technology. The Ministry of Machine Building, for example, is constructing two factories to make robots, and industry experts predict that the Soviet Union will eventually have a viable robot industry—but with a lag time of about 10 years.

The system's most critical failure, however, is in agriculture, where output gains have averaged only 1.8% annually for a decade. Although the Kremlin set out in the early 1970s to boost meat production in order to upgrade the Soviet diet, output has hovered around 15 million tons for the past three years. "They never will be self-sufficient in meat," predicts former U. S. Agriculture Secretary Bob Bergland, who visited the Soviet Union recently.

As in industry, the biggest problem is the lack of rewards for individual effort on either the large state farms or the collectives. By contrast, peasants lavish their labor on private plots of 1½ acres or less, where they are allowed to raise crops and livestock for their own use or for sale in collective farm markets at higher prices than in government-run stores. To spur more output from the plots, which already produce 30% of the country's meat, milk, and vegetables, the Kremlin recently offered incentives such as added fertilizer supplies and free use of collective farm machinery. But any increase in production is likely to be short-lived because the elderly peasants who farm most of the plots are disappearing. "The youngsters would rather loaf on the collective farm and draw their day's pay," says a Soviet observer.

A wasted work force

Because of Soviet agriculture's inefficiency, a far higher proportion of the population remains tied down in agriculture than in any Western industrial country: 23%, compared with 3% in the U. S. This acts as a powerful brake on the economy, because the total Soviet work force will grow by only 0.4%

Bottlenecks: Inefficient farms keep workers tied down in unproductive activities, and the high cost of developing such projects as pipelines in remote regions slows growth.

annually in the decade ahead. "In the 1980s . . . we will have to depend entirely on raising productivity and not on mobilizing additional labor force," Brezhnev warns. But the necessity of keeping so much manpower in agriculture will deprive the Soviets of the big gains in productivity that the U. S., Western Europe, and Japan have achieved by shifting workers from farms to factories.

The Soviet manpower dilemma is heightened by critical demographic shifts that threaten to create political, as well as economic, strains among the Soviet Union's 15 national republics and numerous ethnic groups. What growth there is in the work force will be in Soviet Central Asia, populated mostly by Moslems, and in Transcaucasia—made up of Moslem Azerbaijan and the republics of Armenia and Georgia—where ethnic nationalism runs strong (chart, page 78). The Kremlin will have to try to attract workers from those areas to European Russia, the Ukraine, and the Baltic states, or more likely, locate more new industry and the costly infrastructure to support it in Central Asia.

Losing control

Such shifts will exacerbate political tensions as Russians become a shrinking minority of the total Soviet population. Just as in Czarist days, the Soviet Union is a polyglot empire under a Russian-dominated party, government, and armed forces. The Russian Soviet Republic now accounts for 52% of the population, but that share will drop to 48% by the year 2000 (chart, page 78). The "Slavic core," including Byelorussians and Ukrainians, who traditionally hold important posts in the Soviet establishment, will still account for 69% of the total. But nationalist resentment of Russians persists in the Ukraine.

A longer-range threat to Russian dominance of the U. S. S. R. may lie in Central Asia, vulnerable to Islamic nationalism. By the year 2000, some 27% of the 16-year-old additions to the Soviet Union's pool of potential army recruits and young entrants into jobs and universities will come from Central Asia and Kazakhstan, compared with 44% from the Russian Republic. Tapping that labor pool by moving industry to Central Asia, thus shifting the Soviet Union's industrial center of gravity, will make it increasingly difficult for Russians to keep tight control over their empire.

Soviet planners are also being forced to divert scarce investment funds into costly development of oil, gas, minerals, and hydroelectric power in remote and hostile environments in the Arctic and Siberia as natural resources close to industrial centers are depleted. "East of the Urals, capital investments are higher and wages are higher," says Nikolai I. Ryzhkov, deputy chairman of Gosplan, the central planning agency. "That can't help but affect the growth rate of the plan." To move industry closer to the resources, construction has started on 15 "territorial industrial complexes"—huge petrochemical and metallurgical centers built around gas deposits or hydroelectric projects—aimed at shifting 10% of the country's output east of the Ural Mountains by 1990.

Carrying out the Siberian strategy will be difficult, though. Workers are reluctant to move to the boondocks despite wages of $1,300 a month for truck driving compared with about $400 for comparable work in European Russia. To man West Siberian oilfields, "expedition workers," including Bulgarians, are flown in to work 18-hour shifts for two weeks, and then flown home for two weeks of rest.

Such crash programs are raising natural gas output fast enough to offset falling oil production and stagnating coal output. That is why the Soviets are negotiating to expand gas sales to Western Europe through a 3,500-mi. pipeline from Siberia's Yamburg field that a group headed by Germany's Mannesmann, as well as suppliers and customers in France and Italy, plan to equip and finance with $10 billion in credits. Gas exports through the line could earn $2 billion to $3 billion annually and help pay for Soviet imports of Western food and technology. By contrast, the U. S. Central Intelligence Agency predicts that Soviet oil output will drop to between 10 million and 11 million bbl. per day in 1985, down from 12 million bbl. at present, and Wharton Econometric projects a further decline to 8 million bbl. by 1990. Such a decline could crimp oil exports to the West that currently finance 40% of the Soviet Union's hard-currency imports, totaling about $38 billion this year (chart, page 73). Without that income, the Kremlin would be forced to sell more bullion from its $33 billion gold hoard.

In contrast to such problems, the one sector of the Soviet economy that is booming is military production. The U. S. Defense Dept., in a 99-page report that it released on Sept. 30 to back the Administration's warnings of a Soviet military buildup, cites major expansions at Soviet weapons complexes such as the Severodvinsk submarine-building yard, a huge tank plant, and a major aircraft factory at Ulanovsk. Unlike Soviet civilian industry, the arms plants are able to turn out high-quality products and meet production schedules because they have first call on supplies of material and equipment as well as on top engineers and skilled workers. But by lavishing critical resources on the military-industrial complex, the Kremlin is putting an added brake on the Soviet Union's economic performance. "The very techniques that contribute to the success of the military production sector also impose costs on the rest of the economy," the Defense Dept. says.

Thus, the Kremlin's leaders face a no-win dilemma in allocating increasingly

Michaud/Woodfin Camp

The demographic threat: The fast-growing Moslem population of Soviet Central Asia could become a breeding ground for Islamic nationalism and for political tension.

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scarce resources as the economy slows. They almost certainly will not cut military spending. And they need to maintain their high rate of capital investment—about 30% of GNP annually, compared with 16% in the U. S. Such massive investment is what keeps the Soviet economy growing at all, despite its inefficiency. But the Kremlin will run the risk of both economic and political trouble if it fails to increase the supply of goods to consumers, the third claimant on Soviet output. Workers and managers will have even less reason to work hard if there is little to buy with their earnings. And the turmoil in Poland, which started as protests against scarcities, is a warning of potential problems ahead.

Politicized planning

The Soviet planning system is incapable of solving this dilemma, partly because it is nothing like the rational command mechanism it is supposed to be. Rather, it is an exercise in logrolling and pork-barreling that would evoke envy on Capitol Hill—a "wild democracy," one Soviet minister confided to a Westerner.

Gosplan, the central planning agency headed by 70-year-old Nikolai K. Baibakov, drafted the current five-year blueprint at its gray headquarters at 12 Prospekt Marx, just across from the Kremlin. The plan was published last Dec. 3 and will be enacted into law, probably next month, by the rubber-stamp Supreme Soviet. But bureaucrats have been putting pressures on the shaping of the plan for at least five years. After completing the previous plan, Gosplan started consultations with production ministries to set production targets and to determine industries' needs for the current plan. "Everyone gets on the phone trying to get a fairly easy target and as much input as they can," says University of Houston economist Paul R. Gregory. And ever since Gosplan submitted the draft to the government's Council of Ministers last fall, it has been fair game for officials and party leaders who have their own interests and constituencies to promote. Central Asian party bosses, for example, have been lobbying loudly for water projects, and they are likely to be heard; three of them sit on the party's Politburo.

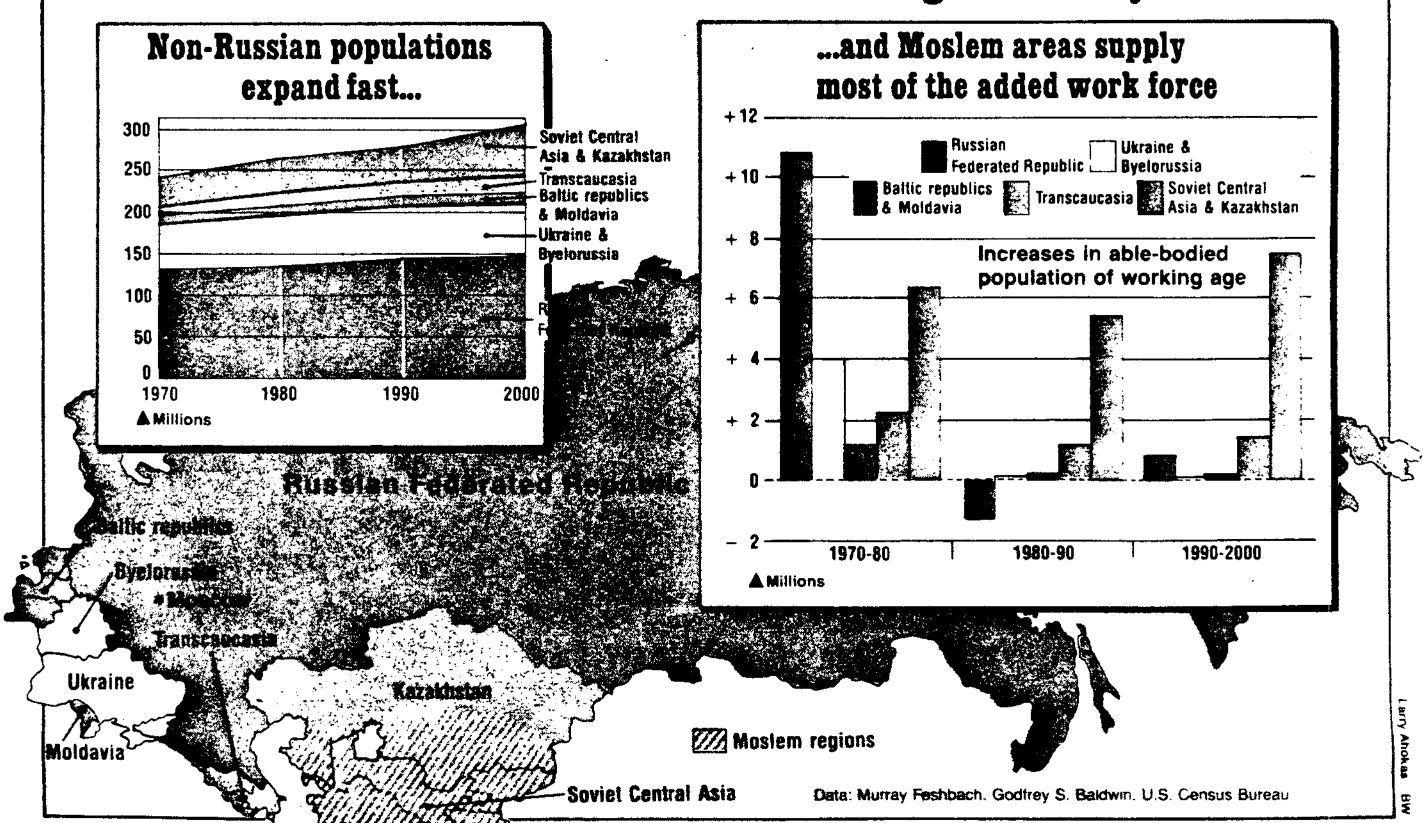
Moreover, says an economist in Moscow, "the completed plan has been obsolete from the day it was published" because it is continually being revised. Enterprise managers regularly call their ministries to arrange for downward target adjustments because of bottlenecks or late delivery of material. Because of the continual revisions, according to University of Pennsylvania economist Herbert S. Levine, "what the Soviets have isn't just centralized planning, it is centralized management."

Whether planning or management, a crucial weakness of the system is the lack of market prices to tell the true cost of resources and determine whether supply and demand are balanced. Setting "shadow" prices that would balance supply and demand if there were markets is difficult. "So they fall back on technical and mechanical allocation procedures that don't take prices into account," says Chase Manhattan Bank economist Donald W. Green. "There is no demand curve thinking."

Furthermore, incentives for managers, based on targets such as output, profit, sales, and quality, offer little reward for innovation because it is so difficult to quantify. "Careerwise, [managers] do a lot better overfulfilling their plan by 1% every year than trying something new," says Charles H. Movit, economist at Wharton Econometric. That lesson was impressed on managers at the Omsk petrochemical complex, which hiked productivity by 48% in the 1971-75 five-year plan by adopting the Shchekino system. But the Ministry of Petroleum Refining forced the plant to abandon the method, and annual productivity growth is back at 2%. "Now the ministry is happy," says management editor Aganbegyan, "because the indices are going up each year."

Paradoxically, the computer—the dream of socialist planners for decades—may stifle moves toward reform

How ethnic Russians are becoming a minority



Data: Murray Feshbach, Godfrey S. Baldwin, U.S. Census Bureau such as decentralized management. Computers have improved resource allocation in individual ministries, according to British economist Martin Cave, but "the computer encourages Party and planning officials to believe there is a central solution." Thus, he adds: "In the Soviet context, the computer is a conservative force."

But a new breed of economists, trained in mathematical techniques such as linear programming and optimization, is gaining influence, according to Levine. "Many are talking the same language as Western economists," he says, and predicts they will be giving different advice to Soviet leaders in the 1980s. "The labor theory of value told their predecessors a lot about the sweat and blood involved in production," Levine adds, "but it didn't tell them anything about marginal costs."

The moonlight economy

Right now, some of the products and services that the official economy cannot supply are being provided by a growing "second" economy. Partly, it traffics in goods diverted from state enterprises and in bartered services ranging from medical treatment to auto repairs. But some of its activities are highly productive. Groups of moonlighting men and women, for example, hire themselves out to managers of high-priority construction projects as *shabashnya rabote* (literally, sabbath labor). For wages of up to $1,600 per month, they work 18 hours a day, seven days a week to help meet critical deadlines.

If the Soviet economy continues to slacken, the Kremlin may react initially by cracking down on this "second" economy and imposing tougher penalties on loafers and managers who fail to meet targets. Such orthodox efforts to make the central planning system work better are likely to appeal to candidates to succeed Brezhnev and other leaders. But eventually, a deteriorating economy may force more basic reforms. The Kremlin will be loath to adopt market prices and more decentralized decision-making, as Hungary has done. Instead, some Soviet-watchers believe, the Kremlin may try to create a more efficient and flexible system by allowing an expanded second economy to provide more unplanned goods and services, while keeping the basic economy under central control.

Such reforms, as a solution to the Kremlin's dilemma, will be more likely in an era of lowered global tensions, Brzezinski says. "If the international context is tense," he says, "the Soviet system—which is, after all, a mobilization system—will be able to regiment the people and keep these dilemmas under control." ■

TRANSPORTATION

United takes on the upstarts

The nation's big airlines have been concentrating on building short-haul services to feed their major hubs since airline deregulation began in October, 1978. They often encounter brutal competition in their busiest markets from new nonunion airlines that offer no-frills service at sharply discounted prices. The established airlines are matching the new entrants on price and also mounting media blitzes to clip the wings of such upstarts as Midway, New York Air, and People Express.

Now United Airlines Inc. is turning to more than just price promotion to recapture the short-haul, point-to-point traffic and critical feed for its longer routes that it lost by stretching the spokes in its route system too far. The new thrust is a marked departure from United's earlier strategy, which had led the nation's largest carrier to drop most of its shorter routes and even put its short-haul aircraft up for sale.

Now United has set up its own low-fare service—Friendship Express—to compete against the upstarts. Thanks to having the right equipment and looser work rules than its trunk carrier competitors, United stands a good chance of being the only established airline to make a profit flying short-haul routes at the rock-bottom fares being forced on the industry by the new entrants. "It's good defensive tactics against the likes of us," says one upstart airline executive. "The strategy minimizes their losses and lets them control more traffic on the United system."

Friendship Express already accounts for one-sixth of United's flights, and fully half of its short-haul operations. "If United can pull it off, it'll be the biggest thing in aviation since deregulation," says Roy Pulsifer, an associate director in the Bureau of Domestic Aviation at the Civil Aeronautics Board. "For the mature carriers, price is going to drive down costs. At the new entrants, it's the other way around."

Seeking concessions. All the "dinosaurs," as major airlines are frequently called, are pressing for productivity concessions from their workers, and often wage cuts as well. But United has had the most success. "If we are going to compete against low-cost, low-price competition," says John R. Zeeman, United's vice-president for passenger marketing, "we have got to do it on a cost basis" as well as on price.

Two factors have helped United: the decision to hold on to its 49 Boeing 737s, the same type of twin-jet airliner used by the new entrants, and the contract United signed with its pilots last August (BW—Aug. 17). That agreement increases the number of hours pilots will fly each month, loosens many costly work rules, and reduces to two from three the crew size in the 737 cockpit. Smaller airlines all fly twin jets with two-person crews.

United claims that it anticipated the impact of new competition well before New York Air's 56% fare cuts last April increased traffic in the New York-Cleveland market, which United had dominated. United matched the fare and

Mickey Pfleger

An array of bare-bones services and cheap fares to lure travelers.

watched its average passenger load on that run soar to 79% from 54% the two previous months, even with New York Air's 10 flights a day taking off 75% filled. But United was not making money on the service.

Heading west. To do so, United figured it would have to duplicate the entire upstart operation, not just its price, and on June 12 launched Friendship Express. Even the name plays on the image of a bare bones, cut-rate carrier, fostered by the market identity already established by similarly named upstarts.

Friendship Express is based in Cleveland, where United still had a strong