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Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

APRIL 1987

Gorbachev's Policy on the Private Sector:
Two Steps Forward, One Step Backward

Summary

Approval of a series of legislative initiatives since the 27th Party Congress last March suggests that the Gorbachev regime is embarking on a cautious expansion of opportunities for individual, family, and small group businesses in the USSR. This new legislation has affirmed the legality of so-called "individual labor activity" and fostered the establishment of member-run cooperatives. To ensure that labor is not diverted from the state sector, the new measures limit participation to students, homemakers, and pensioners. Despite these restrictions, the legislation constitutes one of the regime's most controversial reform steps so far and reflects Gorbachev's willingness to confront past economic orthodoxy in an effort to improve consumer welfare. [redacted]

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Proponents of this legislation hope it can give a quick boost to the Soviet consumer by expanding the range and improving the quality of available goods and services. Many of them may also hope that creating a more favorable climate for legal private businesses will induce private entrepreneurs currently operating underground to come out into the open, and that this will enable the regime to regulate the private sector more effectively. [redacted]

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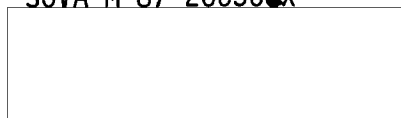
The new laws were preceded by a decree on "unearned income," aimed at tightening law enforcement against operators in the illegal "second economy." Some advocates of an expanded legal private sector see the crackdown on "unearned

This paper was prepared by [redacted] the Office of Soviet Analysis. Comments and questions may be directed to the Chief, National Issues Group, [redacted]

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income" as complementing the individual labor activity legislation. But some conservative officials, perhaps including party secretary Ligachev, have tried to use the "unearned income" decree to discourage private activity across the board. [redacted]

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Any significant growth of legal private economic activity will be impossible without leadership commitment. Yet Gorbachev and Zaykov are so far the only Politburo members to voice strong public support for expansion of the legal private sector. Unless Gorbachev is able to mobilize greater leadership backing that results in increased incentives, including relatively low tax rates and minimal state controls in such areas as prices, significant increases in private activity are unlikely. [redacted]

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[redacted]

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Introduction

The state sector of the Soviet economy has long been notorious for its inadequacy in satisfying the demands of Soviet consumers. This inadequacy creates large and potentially lucrative opportunities for private businessmen* willing to provide quality and convenience Soviet consumers cannot get from the state sector. Although the Soviet constitution of 1977 theoretically guarantees the right of citizens to engage in self-employment for private gain (except for a specific list of proscribed activities), in practice authorities have usually taken a hostile attitude toward these activities and the constitution has provided private entrepreneurs scant protection against official harassment. Moreover, until now there have been virtually no legal sources of supply from which private businessmen can obtain materials and equipment and any earnings derived from legal private activities have been subject to a steeply progressive income tax. Consequently, rather than attempt to cope with the obstacles to operating legally, most individuals responding to the lure of opportunities in the consumer sector choose to operate underground. Together these individuals constitute a large, unregulated "second economy." [redacted]

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Controversial Proposals

Reform-minded Soviet economists have long proposed taking steps to facilitate the expansion of private business by affirming the legality of self-employment and creating new opportunities for groups of individuals to form profit-sharing cooperatives. They point out that such arrangements have been adopted in Hungary and East Germany and make a significant contribution to the consumer sector in those countries. [redacted]

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Reform economists argue that private business could better mobilize labor not employed by the state such as homemakers, students, and pensioners, and expand the supply of goods and services available to the population. They also argue that the private sector could respond more rapidly and flexibly to consumers' demands for goods and services of higher quality and greater variety than the state sector now provides. Some have argued that the beneficial effects of expanding the private sector would spill over into the state sector: Competition from private business would end the monopoly situation that allows state enterprises to dictate the range, quality, and cost of services available to Soviet consumers and force the state to do a better job of satisfying demand. (Competition from the private sector, however, would not force an improvement in the performance of state enterprises in the absence of effective penalties for poor

* The term "private business" is used in this memorandum to denote economic operations organized and managed outside the traditional state sector of the Soviet economy (although subject to state regulation), including individual and family-run operations as well as the new type of cooperatives called for in recent Soviet legislation. The new cooperatives are partnerships organized by groups of at least 3 individuals who run the operation collectively and share the profits.

performance.) []

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Some Soviet officials also observe that taking steps to encourage private businessmen to operate legally would enable the regime better to regulate the private sector. Proponents of this argument point out that a burgeoning "second" economy already exists, but, since it operates underground, the regime is unable to control it through taxation of incomes, controls on prices, and restrictions on time spent working in jobs outside the state sector. As a consequence, these officials believe that the illegal private sector in many cases hurts the consumer rather than benefits him; large-scale theft and diversion of resources from state stores and enterprises lines the pockets of underground entrepreneurs and the corrupt officials who assist them. []

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Proposals to affirm the legality of private activity and expand its role have evoked strong opposition from officials and segments of the public concerned that undesirable consequences will accompany any such moves. Many party traditionalists, who believe in the Marxist principle that the party's monopoly of political power is based on monopoly of economic power, fear that expansion of the private sector could ultimately undermine political control. Those traditionalists fear that an expansion of legal private activity would make it more difficult to regulate the private sector (rather than less difficult as many reformers probably believe). As good socialists, party traditionalists believe that state ownership represents a higher plane of economic organization, therefore any expansion of the private sector is inherently regressive. []

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Thus, conservative officials publicly argue that expansion of the legal private sector will create additional opportunities for individual enrichment that are incompatible with egalitarian socialist principles. Many officials voice concern that theft of raw materials and spare parts from state enterprises will increase because private businessmen have few other sources of supply for those items. Managers of farms and factories fear that the creation of potentially lucrative opportunities in the private sector will lure away their workers. Ordinary citizens, in letters to the media and remarks made directly to Gorbachev during his public walkabouts, have complained bitterly about high prices charged by private repairmen and vendors. []

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The Regime's Response

Taken together, four policy initiatives since the party congress in March reveal the outlines of the regime's complex response to the debate over the role of private business in the Soviet economy. The initiatives contain a mixture of liberalization and regulation that attempts a difficult balancing act--providing the benefits proponents claim while avoiding the negative consequences opponents fear:

The Law on Self-Employment

The new law, approved by the Supreme Soviet in mid-November and scheduled to take effect on 1 May, affirms the legality of self-employment ("individual labor activity" in Soviet parlance) in a range of activities from handicrafts to medical service. Some features of the law--the encouragement of contractual relationships with enterprises,

measures to facilitate access to raw materials and tools--suggest an effort to give private businessmen the wherewithal to operate. But authorities acknowledge that other provisions of the law were designed to prevent diversion of labor from the state sector. Participation is limited to housewives, students, pensioners, and state employees working during their free time. Members of the immediate family may participate, but hiring of outside labor is strictly forbidden. [redacted]

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The law contains other disincentives to full-time self-employment:

- The new law makes no provisions for private pension plans or social insurance coverage for the self-employed.
- Workers contemplating abandonment of the state sector in favor of self-employment would lose sick leave, vacation, and disability benefits.
- Persons other than pensioners, students, and housewives who chose to earn their living from full-time self-employment rather than work in the state sector would potentially risk prosecution under the state's "anti-parasite" laws, which remain in effect. [redacted]

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The self-employment law also requires that individuals register with the state before setting up shop and calls for a "progressive" tax on individuals' net income to prevent "excessively high" incomes. [redacted]

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Regulations on Forming Cooperatives

Decrees approved by the USSR Council of Ministers in February create new opportunities for groups of not less than three persons to form profit-sharing cooperatives to engage in three types of business--consumer services, food service, or production of consumer goods. Cooperatives may contract with state enterprises for transportation and repair services. Cooperatives have the right to plan production, set prices, and determine members' wages and work rules independently, according to the decree. Participation in the cooperatives is subject to the same limitations applied to self-employment. Cooperatives pay an income tax (rate unspecified) to the local government and retain the remaining profits for production development, social insurance funds, and wages. [redacted]

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The February decrees represent a step forward from regulations issued in October that permitted the formation of cooperatives to recycle raw materials or produce consumer goods from scrap. Those regulations were issued on an "experimental" basis and their application extended only to limited areas of the USSR. The regulations specify tax rates that would be phased in gradually, peaking after three years at 35 percent of the cooperative's net income. [redacted]

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The Law on "Unearned Income"

This measure announced 1 July 1986 was aimed at corruption by officials and ordinary citizens and at theft and tax evasion frequently associated with underground

private businesses. It set stiff penalties for failure to register businesses and pay taxes. New inventory control procedures were also introduced at state enterprises to curtail theft of materials and tools by workers moonlighting in the private sector. The law provoked much debate about what should or should not be considered "unearned" income. In some regions, party and law enforcement authorities interpreted this law as a mandate for an across-the-board crackdown on private activity, driving such activity further underground and reducing the availability of goods and services produced privately. [redacted]

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Regulations on "Shabashniki"

These regulations issued on 15 May 1986 gave explicit legal sanction to itinerant brigades of workers who hire themselves out to farms to perform construction or field work. While the regulations end the ambiguous legal status of the brigades, they may also make the work significantly less attractive by putting strict controls on operations and limiting payment to rates paid for comparable work in the state sector. [redacted]

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The Difficulty of Balancing Objectives

In trying to encourage initiative but wrapping it in red tape, in offering the promise of new opportunities for private business but also raising the specter of prosecution for receiving "unearned" income, the Gorbachev regime appears to be pursuing a precarious balancing act.

- Traditionalists, wary of any steps that might challenge communist principles and undercut party control of the economy, have almost certainly sought to prevent any significant expansion of private business. At the same time, they probably welcomed an opportunity to invigorate efforts to combat unearned income and may have viewed the decree as a license to crack down on all forms of private entrepreneurship.

- Proponents of the new legislation on self-employment and cooperatives probably viewed the unearned income decree as an essential complement to those laws. By increasing penalties on underground private business activity, the unearned income decree may provide an inducement for underground entrepreneurs to begin to operate in compliance with the law. By thus combining the carrot and the stick, proponents would argue, the regime will gain control of a potentially lucrative source of revenue through the income tax on private business, increase its ability to satisfy consumer demand without major adjustments in resource allocation policy, and simultaneously crack down on the growth of the "second" economy outside the regime's ability to tax or otherwise control. This linkage was acknowledged by Leonid Abalkin, director of the USSR Academy of Sciences Economics Institute, who told Western journalists in November that the "unearned" income decree and the self-employment law were originally slated to be introduced in tandem, but that the former was released first because officials found it easier to agree on what to forbid than on what to allow. [redacted]

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Within the leadership, Gorbachev has taken the lead in promoting self-employment and cooperative activity while at the same time offering assurances that the socialized economy will be preserved. During his speech to the party congress in February 1986, Gorbachev endorsed the drafting of measures to crack down on unearned income. At the same time, however, he warned that the measures should not "cast a shadow on those who are receiving additional earnings through honest labor." In a July 1986 speech to Khabarovsk party workers, he urged a search for new forms of "individual labor activity," but during a September tour of a village in the Krasnodar region he condemned those who harbor "private ownership aspirations" and neglect their contributions to the state sector. When asked in Latvia in February whether the USSR was not getting "too carried away by the private sector," Gorbachev responded that "it only seems a private sector at first sight." He went on to defend vigorously the expansion of cooperatives and the legalization of self-employment opportunities, arguing that the "foundations" of the socialized economy will remain intact, even if five to seven percent is "broken off" by self-employment.

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No other member of the Politburo has supported the self-employment and cooperative legislation so vocally, indicating that Gorbachev may face skepticism--if not direct opposition--on this matter. While Yegor Ligachev, Gorbachev's second-in-command within the party, has been generally supportive of Gorbachev's economic reforms, he may share some of the conservatives' concerns about the private sector. In a June 1985 speech to the Central Committee Academy of Social Science, he warned that there would be no "divergence toward private enterprise," and in an August 1986 article published in the journal Teatr, he asserted that "there is no question, nor will there be, of a market economy."

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Conflicting Interpretations

This complex balancing of goals in the various laws regulating private business is likely to perpetuate controversy and confusion. Commentary on the law on self-employment reveals that officials and the public have differing--and sometimes conflicting--interpretations about what the self-employment law does and does not intend:

- A Soviet press correspondent reported that both officials and individual workers see the provisions for regulating income as a key element of the legislation. Workers told her that those provisions are too strict, while officials responsible for financial control complained that they are too lenient.
- US Embassy Moscow reports that the new law is creating a stir among the city's inhabitants, but for widely different reasons. A young doctor, who spoke with embassy officials, reacted enthusiastically, saying he thought the law would enable him to set up a private practice. Another Soviet cynically dismissed the law as simply an effort to tax private activity already going on underground.

- Differing perceptions of the law's main goals are also evident at the official level. Commenting on the law, some officials stress that it is intended first of all to provide the public with more goods and services and accommodate consumers' desires for quality and varied assortment. Others see the law's foremost function as giving the state the ability to control and tax existing, underground activity. [redacted]

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The restrictive spirit of the unearned income law also has contributed to confusion over the limits of private business. Some over-zealous local officials interpreted the law as a mandate to harass vendors at collective farm markets and other private businessmen. In an effort to counteract this interpretation of the law, top legal officials appeared repeatedly in the media to warn that the decrees should not be applied to citizens engaged in legal private business. At the same time, a debate broke out in the press among officials and economists over the proper definition of the concept "unearned income." Some argued that it should apply only to money derived from genuine illegalities such as theft and bribe-taking. Others put forth a broad definition that included gains from doing things the capitalist world would consider common business practice, raising prices when demand exceeds supply, for example. [redacted]

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A Key Role for Local Authorities

As in the past, the new law on self-employment gives local authorities broad prerogative to expand the law's provisions and accords them a key role in providing material support for private business. This is consistent with Gorbachev's efforts to decentralize economic decision-making, but the broad delegation of power to local officials makes it likely that the law will be implemented with wide regional disparities. Prerogatives and responsibilities given to local authorities by the new measures include:

- Responsibility for assisting individual and cooperative business in finding sources of supply, tools, and transportation and in selling their products.
- Authority to permit individuals and cooperatives to engage in additional types of business beyond those specified in the self-employment law. Officials in the Baltic republics have already begun limited experiments with family restaurants, even though the law does not cover restaurants.
- Authority to add to the list of illegal types of business beyond those specified in the new law if it is deemed that their exercise "contradicts society's interest."
- Power to cut red tape to facilitate the formation of new private businesses. Local officials may waive registration requirements for types of activities they designate. [redacted]

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Supporters of an expanded private sector hope that the self-employment law will put an end to the excesses inspired by the "unearned" income decree. Soviet press commentary indicates, however, that the predominant approach by local authorities is to

prohibit rather than encourage private business, particularly in the Russian Republic. Indeed, economist Abalkin told journalists that he thought that individually-run business would not make much headway in the Russian Republic, where there is no strong tradition of such activity and public opinion is predominantly hostile to it. (Cooperatives, he noted, might do better.) Abalkin went on to say that individually-run businesses will find a more hospitable climate in other areas such as the Baltic Region and the Georgian Republic. [redacted]

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Economic Hurdles Ahead

Major questions concerning the balance of incentive and regulation remain to be resolved before the law on self-employment goes into effect on 1 May 1987. The law provides for a "progressive" tax on the incomes of the self-employed. Commentary suggests that new rates will be established somewhere between the 13 percent rate applied to incomes of workers in the state sectors and the current maximum rate of 65 percent on income from private business. Officials also must decide whether private businessmen will be permitted to set their own prices or will have their prices tied to prices charged by state enterprises. [redacted]

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Soviet economists realize that the resolution of these two issues will greatly affect the law's ability to promote an expansion of legal private business. High tax rates and strict price regulation would discourage underground businessmen from going legal. If the stricter penalties for illegal operation contained in the "unearned" income decrees and the self-employment law are vigorously applied by law enforcement authorities, many underground entrepreneurs may simply choose to go out of business. [redacted]

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Arrangements for providing facilities, supplies, transportation, and equipment to individual and cooperative businesses are another potential shortcoming in the new legislation. The Soviet economy has long been plagued by chronic and notorious shortages of these items. The new self-employment legislation encourages individuals to sign contracts with state enterprises for supplies. The state enterprise may have little incentive to provide supplies to individuals on contract, however, given the primacy of meeting state plans for production and sales to other state enterprises, especially if supplying individuals or cooperatives would jeopardize its own ability to meet plans and earn bonuses. Most of the burden of outfitting private business is placed on local government and supply agencies, who likely have neither the will nor the means to meet those needs. Officials and journalists are already predicting that these arrangements will prove inadequate. [redacted]

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The regime is making an effort to address the supply problem. The new cooperatives set up to recycle waste and produce consumer goods from scrap, could provide a creative solution to the supply problem, and an effective one given the extraordinary waste of materials in the state economy. In addition, party and government decrees published on 15 December establish penalties for enterprises holding above norm stocks and authorize them to sell any surplus items to other enterprises, cooperatives, or individuals. The decree instructs supply agencies to set up brokerage services to facilitate the sale of surplus materials and and equipment. [redacted]

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Pressure to Go Farther

The fate of private business in the USSR may ultimately depend on the performance of the state sectors that produce consumer goods and provide services. The Consumer Goods and Services Program announced in late 1985, for example, sets ambitious targets for increased output of goods and services by the state sector. It is doubtful, however, that the investment resources needed to meet the program's goals will be made available given the regime's commitments to defense and the demands of the modernization program in heavy industry. Under such conditions, the leadership may become more willing to push for an expansion of the private sector as a way to improve consumer welfare without requiring a diversion of investment resources and enhance prospects for meeting its commitments to the consumer. [redacted]

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Some economists and officials clearly wanted the leadership to go farther to encourage legal private business now. Geliy Shmelev, section chief at the Economics of the World Socialist System Institute, called for granting paid vacation, sick leave, pensions, and other benefits to private workers. During the Supreme Soviet debate on the self-employment law, a regional party leader argued that more should be done to give private sector workers the same status and prestige as state workers. [redacted]

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Economist Abalkin told journalists in 1986 that he sees the new regulations allowing formation of cooperatives as potentially the most effective element of Gorbachev's private sector policies. Abalkin ventured a guess that while, in his view, individually-run businesses might account for only about 4 percent of national income in ten years, cooperatives could account for as much as 10 to 12 percent. [redacted]

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Cooperatives are seen as ideologically superior to individually-run businesses and more in harmony with Russian traditions. Gorbachev may put increasing emphasis on cooperatives to minimize ideological resistance to an expanded private sector. Legislation already passed gives cooperatives priority over individual and family business in allocation of facilities and supplies. [redacted]

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What to Look For


The success of these new initiatives in the private sector will depend to a large degree on how they are received and carried out by officials and the public. Key developments to watch include:

- Media coverage and commentary on the new laws--A focus on negative consequences of the new legislation such as private business charging high prices or stealing materials from the state would strengthen the hand of opponents who wish to limit or even repeal the new measures. Alternatively, sympathetic publicity for the new legislation and coverage of obstacles that may be preventing the expansion of private business would indicate high level support and might create pressure to relieve those problems. To some extent, media coverage on the new legislation has already taken the latter track.



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- Declarations of high-level support--Gorbachev and other top leaders will probably have to be less cautious and more strongly supportive of the new measures to encourage local authorities to implement them and to push for solutions to economic obstacles that stand in the way of their success.

- Resolution of tax and price regulation questions--These decisions will be a key indication of how far the regime intends to go to encourage the expansion of private business. Effective encouragement of private business will require the regime to set tax rates much lower than the current 65 percent maximum and give private businessmen broad freedom to set their own prices. 

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