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Gorbachev's First Industrial Reform: Lessons Learned for the Next

A Research Paper

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Directorate of
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A Research Paper

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Gorbachev's First Industrial Reform: Lessons Learned for the Next

Summary

Information available as of 6 June 1991 was used in this report.

The industrial reforms in Gorbachev's October 1990 economic program and May 1991 "anticrisis" plan are the most ambitious the country has adopted to date. They call for the eventual elimination of such pillars of the system as centralized planning, fixed prices, and the state's monopoly of the ownership of property, which together bear much of the blame for the dismal state of Soviet industry.

A previous package of reforms, however, had similar if less far-reaching objectives and proved a failure. Three years after their introduction in 1988, these reforms have led to a deterioration in industrial performance and widespread confusion among enterprise managers, who continue to founder in an economy governed by neither plan nor market.

An examination of the problems encountered by that reform program suggests some fundamental flaws that also appear in the new one.

Preservation of Central Powers. Despite its calls for greater enterprise autonomy, the first reform program suffered from the regime's continued unwillingness to relinquish the reins of power. It retained the framework of mandatory five-year plans, along with numerous new and old government bodies to help formulate them and monitor their implementation. The result was a halfway house of reforms that tried to change incentives but left in place the main elements of socialist central planning.

The new program perpetuates that error by retaining a strong "transitional" role for the central bureaucracy and locking in a high percentage of centrally dictated state orders until at least the end of 1991. Although it calls for the eventual dismantling of the old government bureaucracy, a reorganization plan approved earlier this year made no significant reduction in its size.

Postponement of Price Reform. Reluctance to relinquish the reins of power, combined with trepidation about negative public reaction, led to a postponement of the price reforms called for in the first reform package—a mistake that reverberated throughout the economy and undermined the rest of the program:

- Because enterprises had no rational price system to guide their production decisions, the regime had no assurance that lowering state orders would result in a judicious mix of output and abandoned its plan to do so.

- Similarly, the supply system could not be released from central allocation without an alternative method—prices—to perform the allocative function.
- Efforts to make the enterprises financially self-sufficient also were doomed as long as many were forced to sell their products at the unreasonably low prices set by the center.

In the new reform program, the regime raised some wholesale and retail prices, but it continues to subsidize many basic goods and to delay the deregulation necessary to make prices responsive to supply and demand.

Ambiguous Directives. The reforms introduced in 1988 were products of political compromise. Because of leadership differences about the scope and pace of reform, sensitive issues were glossed over, and the resulting legislation was full of loopholes and ambiguities that opponents of the reforms were able to use to prevent their implementation.

The 1990 program was more radical in its stated aim—"the transition to a market economy"—but similarly vague on implementation. This time the critical factor was no longer a divided Politburo but a President and legislature unable to settle on one of several alternatives. The result was a set of vague "guidelines" that also will be subject to interpretation and selective implementation. Where the first program was vague on the division of powers between the ministries and enterprises, the new one fails to adequately delineate the powers of the center and the republics—an even more critical ambiguity that has become the subject of a continuing political battle.

In addition to repeating the errors of the previous reforms, the new program commits a serious mistake of its own: the policy of "stabilization first." In an effort to gain control over galloping inflation and mounting consumer shortages, the regime has put some essential reforms on the back burner until the current economic crisis is alleviated

Enterprise managers are already complaining that this new strategy reduces the autonomy of the enterprises and is a disincentive to increased production. Moreover, stabilization by administrative edict almost certainly will prove elusive at a time when so many of the center's commands are being ignored. The pursuit of this strategy, in our judgment, can only ensure that Gorbachev or a successor regime will be forced to revisit the issue of industrial reform—this time under even more dire economic circumstances

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Gorbachev's First Industrial Reform: Lessons Learned for the Next

Introduction

One of Mikhail Gorbachev's greatest challenges has been the creation of an economic system that would meet the needs of a modern industrialized state. The system he inherited, as he was quick to admit, failed to provide the proper signals for industrial production and investment, retarded modernization and innovation, and encouraged massive waste. A package of reforms designed to restructure that system was approved in 1987, introduced in stages beginning in 1988, and amended by a series of measures that first broadened and then restricted the rights of Soviet enterprise managers. This paper examines the impact these changes have had on the modus operandi of those managers and what their response portends for the future of a second generation of industrial reforms now scheduled for implementation over the next 18 to 24 months.

Gorbachev's First Reform Package . . . in Theory

A key element of Gorbachev's strategy to reinvigorate the economy has been his effort to increase the authority and responsibility of the industrial enterprise. By removing the heavy hand of the government bureaucracy, he hopes to make the industrial sector more "self-regulating" and give a much-needed boost to productivity. The package of reforms adopted at a Central Committee plenum in June 1987 was designed to:

- Decrease the number of centrally mandated output targets—state orders—and give the enterprises more authority to make their own production decisions.
- Reduce the central rationing of supplies and introduce a system of direct wholesale trade between providers and users.
- Expand the system of economic accountability—self-financing—that would allow enterprises to keep a larger percentage of their profits in return for footing more of their own expenses.
- Revise centrally set prices—both wholesale and retail—and allow the broader use of contract prices negotiated between enterprises.
- Give the workers a greater sense of responsibility for enterprise performance by letting them elect their own managers.

Planning

Under the guidelines spelled out in the 1987 Law on State Enterprises and decree on planning, enterprises were to independently formulate and ratify their own five-year plans and set their own targets for each year of the plan. This was intended to eliminate the center's notorious practice of "planning from the achieved level," which in the past had caused enterprises to intentionally underproduce to avoid receiving higher targets the following year. To ensure that the state's requirements were met, enterprises were to continue to receive "control figures" that would serve as guidelines in preparing their plans, as well as a percentage of mandatory state orders.[1] The remaining portion of the enterprise's product list was to be drawn up by the enterprise itself on the basis of direct links

[1] The list of control figures, specifying value of output, profit, foreign currency receipts, and "major indicators of scientific and technical progress and social development," was to be established by the USSR Council of Ministers

with consumers—a process that supposedly would require the enterprise to become more responsive to consumer demand to remain competitive with other enterprises.

Supply

To make the supply system more efficient, the reform guidelines called for a gradual transfer from centralized allocation to a form of wholesale trade that allowed enterprises to freely purchase most items, including producer goods, from other enterprises, manufacturers' outlets, or territorial organizations of the State Committee for Material and Technical Supply (Gossnab). Excluded from this system, however, were "particularly scarce goods," as well as all inputs required to fulfill mandatory state orders.[2]

Prices

The basic provisions of the reform program also called for a "radical" reform of prices to be completed by 1990 so that the new prices could be used in developing the 1991-95 plan. Revised industrial wholesale prices and tariff rates in transportation and communications were to take effect on 1 January 1990. No date was set for the introduction of retail prices, except that the price reform as a whole was supposed to be completed by 1991. Contract prices and those set independently by enterprises were to become more common but within certain centrally determined restrictions

Self-Financing

The concept of "self-financing" was eventually to be adopted by all Soviet enterprises. Under this system, enterprises would be allowed to keep a larger percentage of their profits in turn for paying more of their own expenses—for technology, reequipment, incentives, and so forth. First tried experimentally at plants in Sumy and Tol'yatti, the system was extended to 2,500 industrial enterprises in 1987, to enterprises responsible for more than 60 percent of industrial production in 1988, and to all Soviet industrial enterprises in 1989.

[2] Wholesale trade was not to include electricity, crude oil, gas, metal ores, rolled metal, various kinds of specialized equipment, and products suppli~~' for export, defense, and "market stocks" (presumably grain)

Self-Management

Another innovation of the Law on State Enterprises was a provision calling for the democratic election of enterprise managers. Unlike the 1965 law, which specified the appointment of managers by superior organs, the new version called for the election of enterprise directors for five-year terms and of lower-level managers for two- or three-year terms at regularly scheduled meetings of the workers. Between these meetings, workers' interests were to be represented by an elected council, which was to operate primarily in an advisory capacity but was also to have some decisionmaking authority in the utilization of enterprise funds.

The clear intent of this "democratization" was to give Soviet workers a greater sense of responsibility for enterprise performance. As *Izvestiya* noted in its editorial, workers would no longer be able to blame their poor performance on a bad leader, "because they will have elected him themselves." But the reform also was designed to improve the performance of enterprise managers, who would now face pressure from below (their electorates) as well as from above (the ministries).

The Reforms in Practice: "Zigzag Progress"

At the time they were introduced, Gorbachev hailed these reforms as a major breakthrough that would transform Soviet workers into "absolute masters of production." He would later admit, however, that implementation proved far more difficult than he had anticipated.[3] To help alleviate problems uncovered in 1988, the regime ordered a number of important "fixes" designed to further loosen the restrictions on

[3] During a discussion of Soviet economic problems in July 1990, Gorbachev posed the rhetorical question: "Who knew how to act in the initial stages of *perestroyka?*" One of the meeting's participants boldly replied: "I did." Gorbachev said: "We ought to create a commission out of hotheads like this who are absolutely confident about how to proceed. Except that practice shows that hotheads cool down pretty quickly when it comes to actually implementing ideas."

enterprises. When the enterprises behaved in ways that had unintended effects, however, it tightened the reins again, backtracking on reforms that could exacerbate the fiscal dilemma, hurt the consumer, and undermine popular support for *perestroyka*.

Planning

The effect of such inconsistencies is especially apparent in the area of planning. State orders were only briefly lowered and then raised again to levels that have left many enterprises with little more room to maneuver than they had before the reform. At the same time, that brief brush with freedom was enough to undermine the center's control and cause a growing number of enterprises to simply reject their "mandatory" orders—a revolt that, combined with the increased protectionism of the republics, has left the central planning mechanism in disarray

When the reform was first introduced in 1988, many enterprise directors complained that the ministries, taking advantage of ambiguities in the reform directives, were adding their own requirements to those dictated by the State Planning Committee (Gosplan), placing unrealistic demands on the enterprises. In response, the government adopted an interim provision for 1989 and 1990—the remaining years of the 12th Five-Year Plan—that sharply reduced the percentage of state orders and removed them from the control of the ministries. Although the statute was short on specifics, Soviet officials reported that state orders, which accounted for about 86 percent of industrial production in 1988, were to be reduced to about 40 percent in 1989 and cut back even further in 1990.

During 1989, however, shortages of food and consumer goods threatened to undermine popular support for *perestroyka*, and the regime responded by reinstating the orders it had just reduced. For example, it decreed that the production of virtually all supplies needed by the agricultural sector—from combine harvesters to fuel and batteries—and most basic consumer goods would be totally governed by state orders

State orders were quietly increased in other sectors as well. A September 1988 article by Leonard Vid, a deputy chairman of Gosplan, indicated that state orders in 1989 were to be cut from 86 to 42 percent in the metallurgical sector and from 87 to 34 percent in timber and wood processing. But those planned cuts were evidently rescinded, and, by December 1989, Premier Ryzhkov was calling for state orders in the same sectors to be *reduced* to *90* percent in 1990.[4]

[4] This kind of behind-the-scenes manipulation, added to other data deficiencies, precludes any definitive conclusions about the impact state orders have had on enterprise performance. A spot check of the few available numbers suggests that the percentage of state orders assigned to a given sector had no dramatic effect on its fulfillment of the 1989 plan. For example, according to official statistics, the automobile industry, where state orders supposedly were responsible for only 21 percent of overall production, managed to fulfill 96 percent of its plan, while the producers of color television sets, operating under 100-percent state orders, fulfilled 97 percent. however, suggests that some plants with low state orders, fearful about their ability to secure needed supplies, managed to lower their plan targets accordingly

The regime's reluctance to reduce state orders met with a mixed response from enterprise managers, depending on which hat—supplier or consumer—they were wearing at the time and the particular circumstances of their enterprise. As Premier Ryzhkov complained in a speech last year:

> *When a person appears as a producer, he invariably proclaims the slogan: 'Give me a free hand! Set me free!' As a rule, this is heard in the first part of all presentations. As soon as we move on to problems which the speakers experience as consumers, it is said categorically: 'Give me everything down to the last bolt!' This is the mentality of prominent economic managers at present.*

Some enterprises found a high percentage of state orders advantageous because it gave them first claim on resources that were in short supply. Those enterprises whose products were priced artificially low, however, found state orders less profitable than those that could be sold at negotiated prices. Still others complained that a high percentage of state orders gave them less freedom to make changes in the "assortment plan," limiting their flexibility to shift to the production of more profitable items.

The main effect of the regime's inconsistencies, however, has been to increase the willingness of the enterprise to challenge those orders it believes will prove unprofitable. In fact, refusal to accept assigned state orders has now become so commonplace that Gosplan has had to impose new sanctions on the offending enterprises. Under regulations adopted in 1990, firms refusing to accept their state orders face reductions in their centrally allocated supplies, while those failing to fulfill them have to pay a 50-percent surcharge on the cost of bank loans. In still another sign of the times, the government's State Arbitration Board (Gosarbitrazh), which had refused to handle state orders disputes when the complaints were coming from the enterprises, has begun to accept those cases now that the state has become the chief complainant.

Ironically, as the resistance to centrally dictated orders has grown, the increased assertiveness of the republics has led republic and local officials to levy their own "state orders" on enterprises, and enterprise managers are finding those taskings even more difficult to challenge than the center's. As Gossnab Chairman Pavel Mostovoy recently pointed out, when local orders are combined with the center's, they frequently amount to more than the plant is capable of producing, leading local authorities to resort to a primitive form of arm-twisting to get their share:

> *Not only the republic but also the oblast and city authorities dictate their will. For example, the executive committee of the oblast soviet tells the recalcitrant enterprise: 'If you don't want to obey our decisions, all right, we'll turn off your electricity, heat, and gas, and we'll stop your food supplies.'*

For some enterprises, therefore, the tyranny of the center has simply been decentralized and made even more fearsome at the local level.

Supply

The regime's failure to make a substantial reduction in state orders has been accompanied by a slowdown in the planned transition to wholesale trade. Although the State Committee on Statistics (Goskomstat) reported that the volume of wholesale trade in 1989 was almost three times that in 1988, it still accounted for less than 15 percent of centrally allocated supplies that year, and there has been no credible evidence of significant progress since. Some Soviet economists privately have labeled the reform a fiction, claiming that virtually all supplies continue to be delivered at the direction of Gosplan or Gossnab or on the basis of previously existing arrangements.

Those enterprise managers who *do* attempt to negotiate their own contracts with suppliers often find themselves at the mercy of monopolies that use their positions to extort material and equipment that they need themselves.[3] This desperation for supplies has converted the wholesale trade concept into what one enterprise manager has described as a "primitive barter exchange" (see inset). The practice of reinstating state orders when central supplies of materials become depleted also has created considerable disorder, forcing some enterprises to renege on previously negotiated contracts to meet their new commitments.

Ironically, efforts to reduce the ministries' interference in enterprise decisionmaking have also reduced their ability to "grease the wheels" to alleviate these supply problems

[3] The need for demonopolization was illustrated by a recent Soviet study that found almost 95 percent of the machinery products offered for unlimited wholesale trade were manufactured by three or fewer producers

Wholesale Trade? Barter Is Better

An* Izvestiya *article in May 1990 complained:

Some 1,600 enterprises that have a monopoly on their type of output continue to conduct a policy of commodity diktat, which in some cases is taking on ugly forms. In return for output, consumers are asked to provide Japanese video equipment, Peugeot cars, or other goods of this kind. . . . Some suppliers are demanding that workers be assigned to them or simply that they be provided with detergents.

The resulting disruptions have forced the regime to admit that its gradualist approach to the introduction of wholesale trade has not worked. The frustration this has produced was evident in a recent outburst by former Deputy Premier Abalkin:

> *Do you know how long we have been discussing changing over to wholesale trade? Exactly a quarter of a century. Since 1965. Scientific conferences have been held, dissertations have been defended, articles have been printed, monographs have been published, but we are no closer to the market today than we were then, and we might even be further away from it. Twenty-five years of discussion and no progress.*

Prices

A list of revised wholesale prices for the industrial sector was distributed but never implemented as planned in 1990. When the trade unions protested that the new wholesale prices for energy and transport—the first prices scheduled for revision—would reduce enterprise earnings and workers' wages, the regime caved in to popular pressure once again and

Higher Prices? Blame the System!

An enterprise director writing in Moskovskaya pravda *defended himself from charges that the enterprise was callously jacking up its prices in the pursuit of profits:*

It is the planning system that is to blame for this. According to the control figures for our association, we are required to increase our output by a quarter but to more than double our earnings. It is impossible to achieve such a colossal increase in earnings by reducing the prime cost of our products. Prime costs cannot be reduced endlessly. There is a limit. There is only one way to meet the profit goals: at the customer's expense.

The Three Models of Self-Financing

In the Law on State Enterprises, two models of self-financing were spelled out, and the enterprise—with the permission of the ministry—could select either one. The first provided for calculation of the three enterprise economic funds from profit on the basis of normatives (rations between an enterprise's profits and the deductions taken from those profits) and a separate calculation of the wage bill on the basis of output. The sum of the wage fund and the three economic funds constituted the enterprise's self-financing income.

In the second model, wages were calculated on the basis of enterprise income after repaying material expenditures from earnings. A portion of the enterprise's profit, determined by normatives, was allocated to the production development fund and the social development fund, and the residual constituted the combined wage and incentive funds.

A third model, later pushed by the regime, was designed for firms operating under a lease contract. This model was similar to the second model in that wages were directly linked to profits. Unlike the second model, however, the enterprise was no longer fettered by normatives governing the distribution of profits.

postponed the entire wholesale price reform for another year. At the same time, decisions on the timing of the politically sensitive issue of retail price reform were pushed even further into the future.

Despite the regime's failure to follow through with centrally administered price reform, some enterprises succeeded in setting their own. Many enterprises tried to increase their profits not by reducing costs but by raising those wholesale prices that could be negotiated and by phasing out the production of low-priced goods that were unprofitable but sorely needed by the consumer (see inset). To help prevent this, the government in early 1989 and again in early 1990 issued decrees curtailing the freedom of enterprises to negotiate prices by imposing limits on profit rates, confiscating "excess" profits, and restricting the range of products for which contract prices could be set. These restrictions not only required the "suspension" of certain articles of the Law on State Enterprises but also the establishment of a new Council of Ministers commission to monitor enterprise compliance.[4]

[4] In March 1990 Gossnab Chairman Voronin revealed that the commission's inspections had resulted in reductions of "unjustifiably high" prices on 13,000 items and forced the enterprises to forfeit about 200 million rubles in profit they had earned by raising those prices.

Self-Financing

The self-financing system, adopted industrywide in 1989, was supposed to give enterprises the incentive to increase their profits by making their operations more efficient. For enterprises operating under the so-called second and third models—linking wages directly to profits—it has sometimes had that effect (see inset). The reform has proved less effective, however, for the vast majority of enterprises still working under the first model, which calculates wages on the basis of output rather than profit and offers little incentive to reduce expenditures.

The decision to postpone a planned price reform meant that many supposedly "self-financing" enterprises were forced to sell their products at artificially low prices. This and other inequities in the enterprises' starting positions led to the establishment of individual "normatives"—ratios between an enterprise's profits and the deductions taken from those profits—that allowed the ministries to set favorable deduction rates for the less profitable enterprises and stricter ones for the most profitable, thus defeating the purpose of the reform. Additional normatives governing the internal distribution of profits also placed further limits on enterprise decisionmaking authority.

To help reduce the disincentive these normatives represented for the more efficient enterprises, the regime at first allowed the enterprises to keep 70 percent of their above-plan profits. That incentive was rescinded in 1990, however, when it became apparent that enterprises were simply lowering their plan targets in order to overfulfill them. As then Premier Ryzhkov explained, "We were urged to leave 70 percent of above-plan profit for the enterprises because the enterprises were poor, but today it is the state that is poor."

Wages. Self-financing had an equally dramatic impact on incomes, which grew at a much faster rate than anticipated—9 percent in 1988, 13 percent in 1989, and 17 percent in 1990. Instead of building popular support for reform, these increases only widened the gap between purchasing power and the existing supply of goods and services. The continuing shortages of consumer goods, combined with the failure to require a more direct linkage between wages and enterprise profits, also eliminated the potential to spur labor productivity, which, contrary to the hopes of reformers, has failed to keep pace with the growth of wages.

The regime's first reaction to this wage spiral was to reimpose central controls

In a further effort to control wage growth, a law that became effective in October 1989 established a progressive tax on increases of greater than 3 percent in

[1] The number of enterprises operating under the second model of self-financing rose from about 1,000 at the end of 1988 to more than 2,700 by June 1989. By the end of 1989, when the regime began touting the third model—leasing—as the superior option, Goskomstat stopped reporting the number of enterprises that had adopted the second model. By the end of 1990, 2,400 enterprises, responsible for 5.2 percent of the overall volume of industrial output, were operating under lease contracts.

the wage funds of all enterprises except those that produce consumer goods. This measure proved ineffective, however, as the enterprises—under pressure from disaffected workers and heightened competition from high-paying cooperatives—continued to find ways to increase wages and other worker benefits:

- Some state enterprises switched temporarily to cooperative status to avoid being subject to the tax.
- Others opened new subunits for "enterprise development"—a capital expense exempt from the tax on wage growth.
- Many simply increased their wages and paid the required taxes from idle enterprise funds.
- Some enterprise directors complied with the wage restrictions but offered their workers other financial benefits, such as rent-free apartments

Investment. By taxing the enterprises' wage funds, the regime was also hoping to steer more of their profits into capital investment. Although self-financing requires enterprise managers to finance a larger share of their own investment, they often have had little incentive to devote these funds to modernization and reequipment. As former Politburo member Yegor Ligachev once acknowledged:

> *The paradox, you see, is that it is often more profitable for an enterprise to work with old technology and produce a large series of items than to involve itself in modernization.*

Even when the incentive for modernization and reequipment has been there, enterprises often have been hard pressed to find the investment goods they need because so many suppliers' capacities have been taken up with state orders. As a result, Gosplan Chairman Maslyukov reported that, in 1990, Soviet enterprises had accumulated some 40 billion rubles for investment purposes that they simply were unable to spend.

Self-Management

The experiment in democratizing workplace management is perhaps the most widely acknowledged failure

Disillusionment Over the Labor Collective Council

This excerpt from a letter to a Soviet newspaper expresses the disappointment many workers feel about the role played by the labor collective council:

More than a year ago I was elected to the labor collective council for our railway carriage repair works. I thought the council was something like a collective manager and that now, together with the supervisors, we would address all the vital problems. . . . Last year we announced our lack of confidence in the head of the cafeteria, S. Tarasova. And? She works as before, and the food in the cafeteria is still lousy. It turns out we can only grumble a little, and the way matters are decided above is how they will be. . . . In a word, I'm disappointed. And I must confess, doubts are getting the better of me. Do we even need the labor collective councils at all? And if so, what should their role be?

of all the reforms. The planned worker participation in the decisionmaking process was so circumscribed that it increased the very cynicism among workers that it was designed to overcome. Judging from press accounts and the new labor collective councils have played only an advisory role in enterprise decisionmaking and have little or no independent authority (see inset). In fact, contrary to Gorbachev's advice, the councils often have been headed either by the enterprise director himself or someone he selected for the post.

Although workers sometimes complained that ministries rejected their selections for enterprise director, most of the complaints about the elections came from those who found the process too democratic for the good of the economy (see inset on page 10). In addition to the disruptions caused by the constant turnover in management, they said the elections favored candidates who promised to make life easier for the workers, rather than those who challenged them to work harder. As a *Pravda* editorial complained:

> *Workers have elected not the strongest and most intelligent, but the most convenient, the most obliging, the soft options. And sometimes downright useless people. A nice guy and that's all. Whether he was right for the job never entered into it*

In a speech to the Supreme Soviet in October 1989, Premier Ryzhkov openly confessed that the reform had been ill-conceived:

> *As world experience shows—and it now shows us too—the head of an enterprise must not be dependent on the changeable moods of the collective under his management.*

Another Vote Against the Election of Enterprise Directors

A party secretary at the Kuybyshev Liquor and Vodka Plant sent the following letter to the Central Committee:

A new director took charge of our enterprise 6 years ago. Before he arrived, some employees had been stealing products and selling them on the black market. Then the new administrator launched a bitter struggle against drinking and absenteeism and shut off avenues for pilfering. Naturally, this did not please the thieves. Hiding behind demagogic phrases about democratization and *glasnost*, this band of 'injured and offended individuals' insisted that a vote be taken on the director as well as the heads of subsections. Our collective has been in a state of nervous tension for a month now. We are well aware that the results of the election will not be objective. It seems to me that many labor collectives in processing industries, where pilfering is widespread, are not morally prepared to elect their own administrators.

Instead of selecting directors by plebiscite, a new law on enterprises calls for the directors of state enterprises to be nominated by central authorities and then confirmed by enterprise workers.[7]

Impact on Industrial Output

In sum, Gorbachev's first industrial reforms have done nothing to improve Soviet industrial performance. By the end of 1990, overall industrial production actually was in decline and had slumped almost to the level of 1988, when the reforms were initiated. Moreover, a number of these reforms clearly contributed to the woes of the Soviet consumer. Output of consumer durables was still far below target and not enough to stock the bare shelves of state stores. Wage increases resulting from self-financing continued to grow faster than planned, creating excess purchasing power that exacerbated the shortages of consumer goods. While other factors—ethnic disturbances, labor strikes, and local protectionism—contributed to industry's decline, it was apparent by the end of 1990 that the reforms on which so many hopes had been riding had become part of the problem and not the solution.

Reasons for Failure

A number of factors contributed to the failure of Gorbachev's first package of industrial reforms.

Preservation of Central Powers

Despite its calls for greater enterprise autonomy, the first reform program suffered from the regime's continued unwillingness to relinquish the reins of power. It retained the framework of mandatory, "stable" five-year plans, along with numerous new and old government bodies to help formulate them and monitor their implementation. The result was a halfway house of reforms that tried to change incentives but left in place the main elements of socialist central planning.

Postponement of Price Reform

This reluctance to relinquish the reins of power, combined with concern about negative public reaction, led to a postponement of the price reforms called for in the first reform package—a mistake that reverberated throughout the economy and foiled almost every other aspect of the program:

- Because enterprises had no rational price system to guide their production decisions, the regime had no assurance that lowering state orders would result in a judicious mix of output and abandoned its plan to do so.

- Similarly, the supply system could not be released from central allocation without an alternative method—prices—to perform the allocative function.

[7] The method of selecting the directors of cooperatives and other nonstate enterprises is to be determined by the owners of those enterprises

• Efforts to make the enterprises financially self-sufficient also were doomed to failure as long as many were forced to sell their products at the unreasonably low prices set by the center.

Ambiguous Directives

The reforms introduced in 1988 were products of political compromise. Because of leadership differences over the scope and pace of reform, sensitive issues were glossed over, and the resulting legislation was full of loopholes and ambiguities that opponents of the reforms were able to use to prevent their implementation.

Have the Lessons Been Learned?

To its credit, the regime finally came to recognize that these halfway reforms were simply inadequate to the task at hand and, after a number of false starts, adopted a new reform program in October 1990, supplemented by an "anticrisis program" in May 1991 (see inset on page 12). This second wave of reforms, to be implemented over the course of 18 to 24 months, marks a significant advance in thinking that calls for the toppling of such pillars of the system as centralized planning, fixed prices, and the state's monopoly ownership of property—all of which bear major shares of the blame for the dismal performance of Soviet industry.

Our analysis of the fate of the previous reforms, however, suggests that the new program contains many of the same weaknesses that eventually made those reforms so ineffectual.

Preservation of Central Powers

The new program perpetuates the error of retaining a strong "transitional" role for the central bureaucracy. Despite its call for increased enterprise autonomy, it locks in a high percentage of centrally dictated state orders until at least the end of 1991.[a] Athough the program would eventually dismantle the old government bureaucracy, a new reorganization plan approved earlier this year brought no significant reduction in its size. Prime Minister Pavlov described this Cabinet of Ministers as a "temporary" structure designed to meet the economy's needs during the transition period of 1991-92, but he provided no assurances that it would be reduced in size, much less eliminated, at the end of that period.

[a] Although the figures have not been published, told that in 1991 state orders would *average* 70 percent and increase to "90 percent or more" for certain commodities

Gorbachev's Basic Guidelines

According to the "basic guidelines" of the program adopted in October 1990, economic stabilization and the transition to a market economy are to be accomplished in four stages over the next 18 to 24 months.

Stage I	*Reduction of the budget deficit, restrictions on the money supply, and restructuring of the banking system.* *Denationalization and privatization of property, implementation of land reform.* *Phased increase in wholesale prices.*
Stage II	*Deregulation of some retail prices.* *Introduction of income-indexing and other measures to compensate for price increases.* *Further denationalization and privatization.*
Stage III	*Privatization of housing.* *Further deregulation of retail prices.* *Establishment of minimum wage.* *Elimination of financial and credit restrictions.*
Stage IV	*Demonopolization of economy; further denationalization and privatization.* *Further deregulation of retail prices with "most" prices to be governed by supply and demand.*

. . . And the Anticrisis Program

An "anticrisis program" issued in May 1991 was described by the regime as an elaboration of these basic guidelines. In fact, however, it combines both coercive and market-oriented measures in a package that has drawn criticism from both right and left. For example, the program bans political strikes for the rest of this year and establishes a special management regime that prohibits labor strikes in key industrial sectors. At the same time, it calls for market-oriented measures that, if implemented, would speed up privatization of some state enterprises, break up large monopolies, remove most restrictions on middlemen, and lower the tax rate on high-income entrepreneurs.

Many of the implementing decrees of the new program are now being issued by the President, but most are still being drafted by this same bureaucracy, which has a strong interest in self-preservation and little commitment to the cause of reform. When an interviewer recently asked an enterprise director why the decrees "failed to elicit enthusiasm" among industrial managers, the director replied:

> *Because these decrees, as well as government directives, are written by the same people. These people, even if they once knew how metal shavings smell, have completely forgotten it by now. They have not looked into workers' eyes for eons. . .*

Postponement of Price Reform

In the new reform program, the regime finally ordered a number of increases in both wholesale and retail prices, but it continues to subsidize many basic goods and to delay the deregulation necessary to make those prices responsive to supply and demand.

Ambiguous Directives

Although more radical in its stated aim—"the transition to a market economy"—the new reform package, like its predecessor, is vague on implementation. This time the critical factor was no longer a divided Politburo but a president and legislature unable to settle on one of several alternatives. The result was a set of vague "guidelines" that also will be subject to interpretation and selective implementation. Where the first program was vague on the division of powers between the ministries and enterprises, the new one fails to adequately delineate the powers of the center and the republics—an even more critical ambiguity that has become the subject of a continuing political battle.

In addition to repeating the errors of the previous reforms, the new program commits a serious mistake of its own: the policy of "stabilization first." In an effort to gain control over galloping inflation and mounting consumer shortages, the regime has put many much-needed reforms on the back burner until the current economic crisis is alleviated, issuing a number of decrees that would tighten rather than loosen the economic reins (see inset on page 14).

Enterprise managers already are complaining that this new "stabilization first" strategy will reduce the autonomy of the enterprises and serve as a disincentive to increased production. Among the examples they cite are:

- The freezing of all existing contractual relationships through the end of 1991.
- New enterprise taxes that set strict limits on profits and double enterprise contributions to the state's social insurance fund.

Decrees Emphasize Stabilization at Cost of Reform

The Supreme Soviet in late September 1990 granted Gorbachev emergency power to issue decrees on a broad range of economic matters without consulting the legislature. Most of those decrees attempt to stabilize the economy by bolstering central controls at the expense of economic reform.

Decree	***Impact***
Freezing economic ties between enterprises through 1991.	*Intended to relieve supply bottlenecks but will slow development of wholesale trade, hamstring formation of new enterprises, and hinder republic efforts to privatize.*
Allowing enterprises to negotiate wholesale price increases.	*Positive step toward rational pricing is diminished by imposition of state-set price guidelines and 100-percent tax on excess profits.*
Raising interest rates.	*Intended to sop up excess rubles but relies on administrative fiat rather than allowing interest rates to respond to changing economic conditions.*
Creating worker committees to control the distribution of food and other consumer goods.	*Attempt to reduce theft and speculation is a return to administrative control that reflects inability of legal system or ruble to perform its functions.*
Confiscating high-denomination ruble notes.	*Attempt to confiscate black-market profits also hurt legitimate small entrepreneurs who were unable to document past earnings.*
Creating central stabilization fund.	*Effort to cushion transition to new system by enterprises operating at a loss will be financed primarily by the successful enterprises; undermines effort to force enterprises to operate more efficiently and become financially independent ("self-financing").*
Allowing KGB to inspect business inventories, documents, and cash.	*Effort to prevent "economic sabotage" adds to the problems of small businesses and cooperatives that have stockpiled scarce materials to protect against growing shortages.*

- A wage-leveling device that taxes all increases in wages above certain limits at the same rate as profits.
- Strict limitations on the amount of hard currency earnings the enterprises can retain.
- Additional deductions from enterprise funds for a new unionwide stabilization fund

Moreover, stabilization by the traditional means of administrative edict almost certainly will prove elusive at a time when so many of the center's commands are still being challenged by recalcitrant republic officials and enterprise managers. The continued pursuit of such a strategy, in our judgment, will only sharpen the current economic decline and worsen the plight of the Soviet consumer. Unless that strategy is revised and center-republic differences are soon resolved, this year could see GNP fall by 10 to 15 percent. The continuation of such a decline would force Gorbachev or a successor regime to reconsider the adoption of more radical reforms—this time under even more dire economic circumstances.