

CHAPTER 8

PRIORITY DIRECTIONS FOR REFORMS

8.1 This final chapter summarizes the policy recommendations that follow from the analysis concerning economic growth in Belarus.

8.2 **In the longer term, to achieve and ensure sustained growth in Belarus, the authorities need to make a determined push toward advancing a comprehensive reform program to accelerate the country's transition to a market economy.** These efforts should address a number of pending issues in all of the core areas of liberalization, macroeconomic stabilization (including price and exchange rate stability), privatization, and wide-ranging structural reforms. Despite their up-front costs, the structural reforms (including those involving public administration, legal and judicial matters, social assistance and insurance, and infrastructure) represent a critical element of the sustainable growth strategy. Box 8.1 highlights major government reforms programs.

Box 8.1: Major Government Reform and Development Programs

Many of the recommendations offered in this chapter, such as a reduction in the tax burden and the modernization of the tax structure, further disinflation, export diversification, FDI attraction, improvements in the business environment, etc., are in line with the objectives spelled out in the various government development programs, including the following:

- Program of Socioeconomic Development for the Period 2001-05
- National Program of Export Development for the Period 2000-05
- Program of Structural Changes and Increase in Competitiveness of the Republic of Belarus
- Annual Programs of State Support for Small Business Development
- National Program of Investment Attraction into the Republic of Belarus until 2010
- National Sustainable Socioeconomic Development Strategy for Belarus until 2020.

However, the programs often contain conflicting objectives and there has been no analysis of trade-offs stemming from the attempt to meet many different objectives simultaneously (wage growth versus competitiveness; state support versus the tax burden; export promotion versus import substitution). In addition, no assessment of the opportunity costs of different measures aimed at meeting the same objective was presented. There is also a substantial bias in the programs in favor of administrative measures to reach the objectives, while the government discounts the potential benefits of strengthening market incentives and freeing private initiative.

Given that the government has begun the preparation of major programs for the next five years (including the Program of Socioeconomic Development for the period 2006-10), it is our expectation that the government finds the analysis and recommendations in this report appropriate to be reflected in these new documents.

8.3 The current international and domestic environment seems to be quite favorable to supporting a policy shift toward the acceleration of structural reforms. At the moment, the government is well equipped to mitigate the potential costs of these reforms because the policy settings are largely determined by the growing economy, the positive trends in the perceptions of both the enterprise sector and the household sector, the favorable developments in the global economy, low debt, and strong administrative capacity of the state. This situation could change: various pressures could become stronger and then the same reforms would become politically more costly and fiscally more risky. In short, the current window of opportunity should be used in order to ensure that the authorities' growth objectives are sustainable.

8.4 **In the case of Belarus, the level of FDI attracted should be seen as an indicator that summarizes the economy's longer-term potential to sustain growth and competitiveness.** Belarus seriously underutilizes the advantages of its geographic location as a basis for attracting FDI and restructuring its trade patterns. Addressing this weakness should be a policy priority. FDI inflows would ease the financing constraint, facilitate technology transfer, and provide access to new product markets. Privatization has been an important channel for FDI in the Central European countries and this link might prove important in Belarus as well. Even if there are concerns about widespread foreign ownership, liberalizing economies in the Far East, such as Vietnam, have generated considerable gains from channeling foreign investments through joint ventures.

8.5 **This report, however, is primarily focused on a narrower set of key reform priorities,** which could be sufficiently advanced within the very gradualist approach toward market transformation explicitly chosen by the government. Many of the recommendations that follow are fully consistent with the objectives outlined in the various government development programs (Box 8.1). These recommendations are intended to help the government address the immediate growth challenges, as identified by the report's analysis, which otherwise may undermine the sustainability of the current growth and poverty outcomes.

8.6 **The focus of the report's recommendations is on two inter-related challenges that** the government must address in order to strengthen the competitiveness of the economy as a source of sustainable growth:

- **Imposing stricter market discipline** on the existing enterprise sector in order to accelerate its restructuring and productivity growth at the micro level
- **Encouraging the expansion** of both new and fully restructured traditional firms that have proved to be quite competitive without state support.

Market Discipline

8.7 The main strategy for disciplining traditional enterprises could be summarized as follows:

- **Restructuring and drastically downsizing the existing system of state support to the real sector,** including strengthening discipline in the financial sector through discontinuing the regular recapitalization of state-owned banks and winding down directed credit programs and moving the residual quasi-fiscal activities from the banking sector to the budget. This would help sustain the fiscal balance under lower statutory tax rates. Moreover, this would improve the incentives for enterprise restructuring and equalize business conditions among different types of business entities.
- **Accelerating the exit of non-viable firms.** A shift toward a more pro-business economic policy in Belarus should employ at least some highly visible cases of bankruptcy and the liquidation of non-viable large enterprises. Such liquidations would be important to support several other improvements. First, they would send an important signal to the entire real sector and thus would have an important incentive effect. Second, they would bring some additional fiscal savings. Third, they would release economic resources for new firms.
- **Advancing trade liberalization** to expose domestic enterprises to the discipline of international competition. The immediate priorities include eliminating the existing non-

- tariff restrictions on imports and reducing the use of restrictions on trade with Russia that are inconsistent with the Customs Union agreements.
- **In the agriculture and food processing sector, taking additional steps to harden the budget constraint.** These include: (i) the elimination of implicit subsidies, especially those that are allocated through distorted input prices; (ii) better targeting of government support toward more efficient farms and the equalization of access to state support between private and state farms; (iii) a more aggressive reduction in capacity in food processing; and (iv) a more cautious approach toward merging profitable and non-profitable farms. In the last case, at the very least, managers of consolidated farms should be allowed to implement appropriate rationalization strategies. The government needs to develop aggregate measures of agricultural support using the OECD methodology. There is also a clear need to ensure that the transfers from state-controlled farms to the household sector are rendered more transparent.
 - **Ensuring further strengthening of the financial viability and efficiency of the energy sector companies.** While some progress was made in this area in recent years, more is needed to ensure that these companies are on a commercially sustainable footing and thus could meet a growing commercial demand for energy in a cost efficient way. Specifically, the following policies should be seen as priorities in the sector: (i) completing the phasing-out of implicit subsidies through proper tariff adjustments; (ii) restructuring the existing stock of debt obligations, both external and internal; and (iii) diversifying electricity import.
 - **Preparing the pilot program of large-scale privatizations** to cover several efficient SOEs (including state banks), which could be privatized competitively in an orderly and transparent way.

Encouraging New Business Growth

8.8 **The competitiveness of the Belarusian economy is greatly constrained by the unnecessary business costs** associated with current government policies. The economy is also affected by depressed new entry that undermines its flexibility as well as its capability to withstand potential shocks. There is an urgent need for policy adjustments along the following primary directions:

- **Reducing the tax burden and reforming the tax structure.** The priority is to reduce the incidence of the most distortive taxes, such as turnover and payroll taxes. The latter would create additional incentives to accelerate the pension reform that might include an increase in the retirement age. The existing implicit taxes on the industrial sector should be phased out as well. This will require steps to advance the divestiture of enterprise social assets, to eliminate tariff cross-subsidization in utilities, and to provide of agricultural inputs at fixed low prices.
- **Liberalizing employment and wage policies.** Enterprise managers need more decision making power on labor and wage issues, while the government should discard its use of administrative controls to attain wage increase targets. Combining this policy with a renewed impetus to support new market entry would limit its potential negative effects on overall employment.
- **Advancing price liberalization** by phasing out the residual price control, including downsizing the list of enterprises that are subject to price control as monopolists, as well as the list of regulated export prices. This also includes further liberalization of interest

rates. In agriculture, producer price levels need to be brought much more into line with international prices. In an economy that has been increasingly internationally integrated, the government could rely on competition as a primary tool for avoiding excessive price growth.

- **Reducing the level of day-to-day regulatory costs.** By launching a more efficient dialogue with the enterprise sector, the government should be able to identify and reduce various unnecessary costs that stem from inefficiencies in the regulatory regime. The priority areas for action may include: (i) reforming tax administration to make the system simpler, more stable and predictable; (ii) halting the recent trend of deterioration in customs administration, which includes addressing the issue of customs valuation practices; (iii) liberalizing the procedures for new entry (by reducing the time needed for business registration and simplifying the procedures); and (iv) reducing informal market protectionism and trade barriers at the regional level. It is also recommended to streamline and consolidate the tariff schedule, which would help reduce both the administrative costs of customs clearance and the risk of corruption.
- **Limiting discretionary administrative interference.** The government needs to change the incentive system for the regulatory agencies to discourage their discretion in enforcing regulatory requirements. Among other things, this means a drastic reduction in "unplanned tax inspections" and similar interventions, which are the most detrimental to the business climate. In agriculture, able managers on state-controlled farms should be given much greater decision-making autonomy. Also, businessmen should be offered an independent channel to the central administration to report irregularities in regulatory interventions. This is something that the government could accomplish without a fundamental overhaul in the underlying system of regulations.
- **Accelerating reform in the standards system.** Although the needed legislative framework is mainly in place, slow reform implementation has not yet permitted a switch from the excessive compulsory regulation inherent in the ex-Soviet GOST system to the modern two-tiered system of internationally compatible mandatory technical regulations and voluntary standards.
- **Consolidating recent progress toward a stable macroeconomic environment,** including tightening monetary conditions to lower inflation and taking additional measures to scale down government interventions in the economy (including quasi-fiscal activities) minimize the fiscal deficit and thus lower government financing requirements and interest rates. Sustained macroeconomic stability is critical for strengthening enterprise incentives for restructuring and investment.

8.9 **The government should advance its international integration efforts in the direction of both the WTO and the CIS.** The experience of other transition economies suggests that the trade negotiations, especially those for WTO membership, could become an important driver for a number of domestic reforms. The government should be prepared to advance its trade negotiations by reducing the current level of subsidization in agriculture and industry, including exporters, and, as mentioned above, by reducing the existing non-tariff restrictions on imports. In addition, much more progress is needed in liberalizing and de-monopolizing a number of sectors, such as financial services and telecommunications.

8.10 **The government must invest considerable resources in improving the country's investment image if it is serious about attracting sizable foreign investments.** As a starting point, the government should make highly visible decisions to address the most common concerns of the private sector. For example, the golden share rule should either be abolished or as

a minimum, the existing legislation should be modified in line with the international experience. Its future application should be legally restricted to a narrow set of cases that directly relate to the strategic interests of the state. It would also be advisable to establish a specialized institution for investment promotion which would employ best international practices in this area and could support a broad communications campaign to develop Belarus' image as an attractive location for business and investment. Some degree of administrative control over Free Economic Zone (FEZ) operations should be preserved to ensure that residents of these zones do not abuse their tax customs duty advantages.

8.11 The government could make more extensive use of the Chinese experience of gradual liberalization from the 1980s. In particular, the use of the FEZ mechanism by China as a primary tool for FDI attraction in the early stage of liberalization seems to be quite applicable under Belarus' circumstances. The strengthening and expanding of the existing FEZs in Belarus could be undertaken relatively easily given the accumulated experience. At the same time, an intensive promotion of FEZs, especially those at the borders with Poland and Lithuania, could be a practical way for Belarus to benefit from new opportunities that emerge as a result of the recent EU expansion. However, as international experience suggests, to be successful FEZs must be properly set up and managed, and their development should be integrated with the national reform program: the zones should be seen as an instrument of advancing economy-wide reforms, not as an alternative to reforms. FEZs should be given considerable operational autonomy, and the government should encourage competition between different zones. Private management of the zones should also be encouraged.¹⁴⁸ As mentioned above, some administrative control over FEZ operations should be preserved to ensure that residents of the zones do not abuse their tax customs duty advantages.

8.12 Attracting foreign investments is of special importance for the future rehabilitation and modernization of the energy sector. Over the next decade the sector will face a growing demand for investments that probably cannot be met internally. In order to secure external financing, the energy sector structure and governance arrangements should be adjusted through structural and institutional transformations, such as unbundling the existing monopolies, introducing disclosure and corporate governance principles, and developing public-private partnerships. Establishing an independent regulatory agency and investing in its capacity building would make the sector more attractive to external investors while it would also help to promote both improvements in energy efficiency and a better quality service delivery.

8.13 Belarus also has an opportunity to maximize the benefits associated with its role as an energy transit country. In order to ensure the sustainable expansion of its transit business, Belarus must convince Russia that it represents a reliable and cost efficient route for oil and gas export to Europe. To achieve this, Belarus will need to address the existing reputational issues and also to provide for additional investments by securing commercial borrowing and/or considering options for entering into a joint venture or consortium arrangement with Russia and/or Russia's European natural gas customer(s).

8.14 The food processing industry represents a sector that should become a major beneficiary of FDI. The development of export-oriented food processing requires substantial investment to underpin efficiency and, most important, to ensure adequate product quality. At the same time, experience elsewhere has shown that modernization and efficiency improvements in primary agriculture can occur quickly once they are driven aggressively by a modernized and internationally competitive processing sector.

¹⁴⁸ Madani (1998), Perrin and Sachwald (2004).