

CHAPTER II. STRENGTHENING FISCAL SUSTAINABILITY

2.1 Aggregate budgetary indicators in Belarus give a first impression of fiscal stability. In recent years, Belarus has managed to keep the general government (cash-based) deficit under 2 per cent of GDP, while debt and debt servicing obligations have remained quite low. These indicators tell far from a complete story, however, and mask serious risks to the government fiscal position and to macroeconomic stability in general. Some of these risks have become more apparent in 2002, as a combination of increased financial strains in many Belarusian firms, administrative wage increases, and lower gas subsidies from Russia adversely affected the liquidity position of the government, creating the necessity of substantial fiscal adjustments. Other risks derive from a plethora of off-budget and quasi-fiscal expenditures of the government that can be associated with economic distortions and inflationary pressures. This chapter begins with a snapshot of fiscal aggregates, with the goal of assessing the overall degree of fiscal stability in Belarus. Problems and risks to fiscal sustainability in the short and longer term are identified. A contraction in the size of overall (explicit and implicit) state expenditures will most likely be necessary to ensure not only the soundness of the fiscal position, but the sustainability of growth and competitiveness of the Belarus economy as a whole.

The General Government Budget

2.2 Table 2.1 provides basic information on expenditures, revenues and deficits of the general government¹ from 1999 through 2003 (budget). General government expenditures have been quite stable at about 46-47 percent of GDP. Cash deficits have remained low, ranging from 0.1 percent of GDP in 2000 to 1.9 percent in 2002, and a projected 1.1 percent in 2003. When the budgetary balance is considered on an accrual basis, it increases to -3.1 percent of GDP in 2001, and about -2.0 percent of GDP in 2002. The bulk of deficit financing has come from domestic sources (Table 2.1). Net foreign financing and privatization receipts have been quite small until the exceptional sale in December 2002 of the government stake in the oil company, Slavneft.

2.3 Even confining attention only to the explicit budget given in Table 2.1, the overall level of public expenditures in Belarus is rather high by international standards. This is shown in Figure 2.1, which graphs general government expenditures as shares of GDP and gross national income per capita in 1999 for a variety of countries. Among transition countries, Belarus has a relatively high level of general expenditure, on par with Hungary and considerably higher than other countries with comparable income per capita. Belarus' expenditure in 1999 was about 10 percentage points of GDP higher than in neighboring Russia and Ukraine. Given substantial debt-servicing in Russian and Ukraine, the difference in levels of primary expenditures is even greater.

¹ General Government includes the consolidated republican and local budgets as well as the Social Protection Fund, but does not include state-owned enterprises, quasi-fiscal deficits or other contingent liabilities.

Table 2.1: Fiscal Indicators, 1999-2003

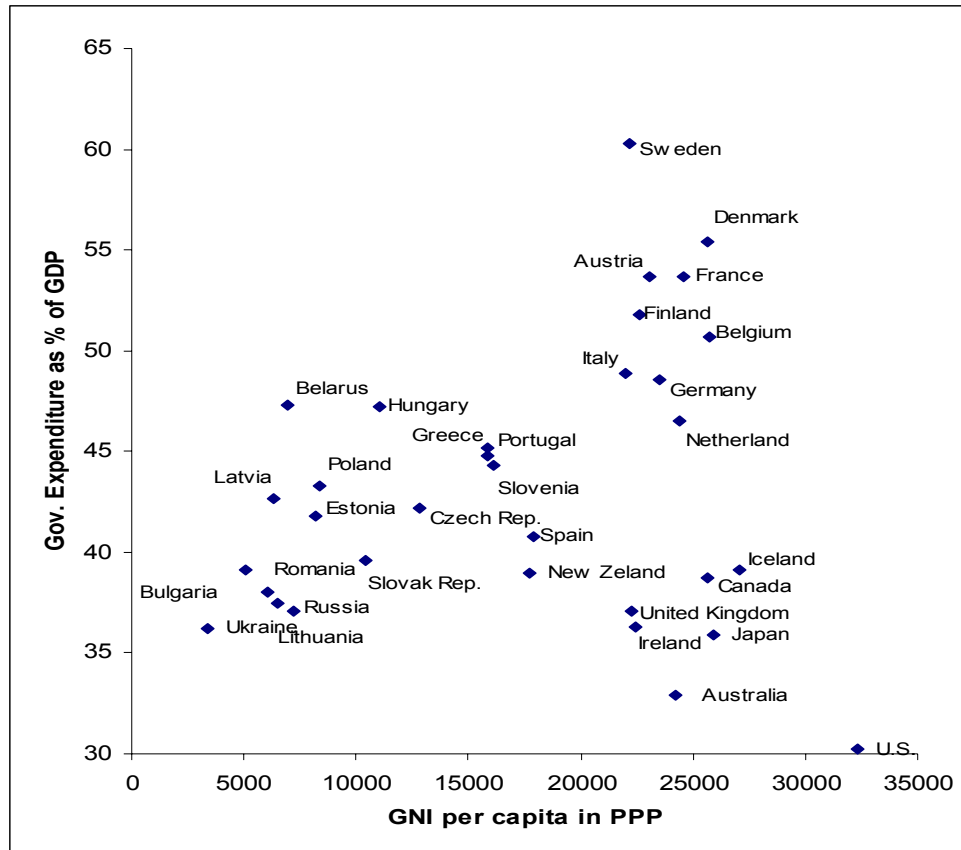
	1999	2000	2001	2002	2003
	Actual	Actual	Actual	Prel	Authorit. Project
<i>(In billions of rubles)</i>					
1.State (Republican and local) budget					
Revenue	1052	3173	5735	8209	10603
Expenditure (cash)	1143	3236	6023	8681	10945
o/w transfer to the SPF	8	8	5	80	143
Expenditure (accrual basis 2/)	...	...	6237	8706	10945
Balance (cash)	-90	-63	-289	-472	-373
Balance (accrual 2/)	...	...	-502	-497	-373
2. Social Protection Fund					
Revenue	326	1010	1984	3065	4403
o/w: transfers from the Rep. Budget	8	8	5	80	143
Expenditure	297	962	2021	3071	4434
Balance (cash)	29	48	-37	-6	-31
3. General government					
Revenue	1370	4175	7714	11194	14863
Expenditure (cash)	1432	4190	8039	11673	15236
Expenditure (accrual basis 2/)	...	...	8252	11698	15236
Balance (cash)	-62	-15	-326	-479	-373
Balance (accrual 2/)	...	...	-539	-504	-373
Statistical discrepancy	3	58	-30	35	0
4. Financing (cash), o/w					
Privatization	3	8	12	427	119
Foreign financing, net	-9	-50	-20	29	41
Domestic financing, net	71	115	303	58	213
<i>(In percent of GDP)</i>					
1.State (Republican and local) budget					
Revenue	34.8	34.7	33.4	32.2	32.2
Expenditure (cash)	37.8	35.4	35.1	34.0	33.3
o/w transfer to the SPF	0.3	0.1	0.0	0.3	0.4
Expenditure (accrual basis 2/)	...	...	36.3	34.1	33.3
Balance (cash)	0.0	0.0	-1.7	-1.9	-1.0
Balance (accrual 2/)	...	...	-2.9	-1.9	-1.0
2. Social Protection Fund					
Revenue	10.8	11.1	11.6	12.0	13.4
o/w: transfers from the Rep. Budget	0.3	0.1	0.0	0.3	0.4
Expenditure	9.8	10.5	11.8	12.0	13.5
Balance (cash)	1.0	0.5	-0.2	0.0	-0.1
3. General government					
Revenue	45.6	45.7	44.9	43.9	45.2
Expenditure (cash)	47.3	45.8	46.8	45.7	46.3
Expenditure (accrual basis 2/)	...	...	48.1	45.8	46.3
Balance (cash)	-1.7	-0.1	-1.9	-1.9	-1.1
Balance (accrual 2/)	...	...	-3.1	-2.0	-1.1
Statistical discrepancy	-0.1	-0.7	-0.2	0.1	0.0
4. Financing (cash), o/w					
Privatization	0.1	0.1	0.1	1.7	0.4
Foreign financing, net	-0.1	-0.5	0.1	0.1	0.1
Domestic financing, net	1.8	1.3	1.5	0.2	0.6
Memorandum items:					
Primary Balance (percent of GDP)	-1.4	0.7	-1.2	-1.3	-0.6
GDP (trillion of rubels)	3.0	9.1	17.2	25.5	32.9
Changes in arrears	0.0	0.8	1.2	0.1	0.0
Stock of arrears	0.1	1.1	1.8	1.3	1.5

Source: Ministry of Finance, SPF, and IMF staff estimates.

1/ State government revenues includes privatization receipts.

2/ Includes changes in arrears.

Figure 2.1: General Expenditure as a Share of GDP, 1999 (percent) and GNI per capita (PPP)



2.4 General revenues are also relatively high, averaging over 45 per cent of GDP over the past three years. As seen in Table 2.2, the largest sources of revenue in Belarus are indirect taxes -- just over 40 percent of revenue comes from taxes on goods and services and some 27 percent from VAT. The third largest source of revenues, at about 17 percent of total revenues, comes from various charges to special budgets. These include both republican budgetary funds (the Agricultural Support Fund, the Employment Fund, the Road Fund, the Nature Preservation Fund and Energy Conservation Fund) and local budgetary funds (the Road Fund, the Nature preservation Fund, the Fund for Support of Pre-schools and the Housing Fund). Direct taxes provide a much smaller portion of overall revenues – just under 10 percent each for personal income taxes and the profit tax.

Table 2.2: General Government Revenues, 1999-2003
(thousand rubels and percent of total revenue)

	1999	1999	2000	2000	2001	2001	2002	2002	2002	2003	2003
		%		%		%	Prel	%	Budget	%	
REVENUE, EXCL PRIVATIZATION	1,052,385	100	3,173,237	100	5,734,597	100.0	8,208,756	100.0	10,602,544	100.0	
REVENUE, INCL. PRIVATIZATION	1,054,904		3,181,031		5,747,089		8,636,109		10,631,422		
CURRENT REVENUE	865,390	82.2	2,545,401	80.2	4,613,623	80.5	6,646,333	81.0	8,812,982	83.1	
CURRENT TAX REVENUES	805,456	76.5	2,433,567	76.7	4,389,113	76.5	6,263,381	76.3	8,379,442	79.0	
Direct taxes on income and profits	235,749	22.4	716,609	22.6	1,315,857	22.9	1,684,505	20.5	2,405,639	22.7	
Personal income tax	89,288	8.5	277,110	8.7	534,233	9.3	773,057	9.4	1,078,475	10.2	
Profit tax	141,694	13.5	395,083	12.5	636,850	11.1	643,339	7.8	985,336	9.3	
Enterprise income tax	4,205	0.4	44,416	1.4	94,200	1.6	136,839	1.7	203,980	1.9	
Other tax on income and profit	0	0.0	0	0.0	50,574	0.9	131,269	1.6	137,848	1.3	
Taxes on wage fund	47,232	4.5	73,092	2.3	154,542	2.7	220,359	2.7	325,761	3.1	
Taxes on goods and services	424,418	40.3	1,336,009	42.1	2,283,822	39.8	3,311,709	40.3	4,509,454	42.5	
VAT	261,992	24.9	817,837	25.8	1,446,701	25.2	2,165,127	26.4	3,167,997	29.9	
Excises	99,687	9.5	253,873	8.0	442,005	7.7	592,029	7.2	828,307	7.8	
Property tax	18,051	1.7	93,200	2.9	237,377	4.1	390,477	4.8	337,383	3.2	
Custom duties	58,011	5.5	141,797	4.5	299,983	5.2	523,591	6.4	641,050	6.0	
Other taxes, fees and duties	21,996	2.1	72,860	2.3	97,533	1.7	132,741	1.6	160,155	1.5	
CURRENT NONTAX REVENUES	59,934	5.7	111,834	3.5	224,510	3.9	382,952	4.7	433,540	4.1	
REVENUE OF SPECIAL BUDGETS &	176,350	16.8	589,874	18.6	1,033,051	18.0	1,470,156	17.9	1,768,207	16.7	

Source: MinFin, IMF, and WB Staff.

2.5 Since 1999, there have been some changes in the shares of major taxes in total revenues. The most significant is the drop in the profit tax from 13.5 percent of total revenues in 1999 to 7.8 percent in 2002. Excise taxes have also dropped from 9.5 percent of total revenues in 1999 to 7.2 percent in 2002. Non-tax revenues have fallen from 5.7 percent of total revenues in 1999 to 4.7 percent of revenues in 2002. In contrast, between 1999 and 2002, the share of VAT in total revenues increased (by about 1.5 percentage points), as have revenues from the special budgets and property tax. Some of the risks inherent with these shifting patterns will be discussed below.

2.6 The cash deficit has been financed primarily by direct credits from the National Bank at interest rates well below market levels. Combined with other substantial off-budget (quasi-fiscal) spending directed through the banking sector (see below), the implied monetary expansion has fuelled persistently high inflation in Belarus. This inflation has also served to reduce the real value of government debt.

2.7 As seen in Figure 2.2, Belarus overall level of debt as a share of GDP has fallen dramatically since 1994 and remains relatively low at just over 10 percent. At the end of 2001, total domestic debt as a share of GDP was 4.5 percent. Just over half of this debt is formally owed to the National Bank of Belarus. The other half consists of short-term securities and promissory notes. Foreign debt in 2001 fell to 7.1 percent of GDP. Controls over foreign borrowing by the broadly defined public sector, including control over the issuance government guarantees for foreign debts of enterprises (see below), have kept the explicit public foreign debt at a relatively low level in relation to GDP and government revenue.

2.8 In sum, relatively low explicit budget deficits over the past few years have kept financing requirements and government debt servicing costs at manageable levels. At the same time, deficit-finance, along with the quasi-fiscal activities of the banking sector, have contributed to persistent high inflation in the country.

Extrabudgetary Funds, Quasi-Fiscal Activities and Contingent Liabilities

2.9 While the snapshot of the fiscal situation provided above covers the explicit general budget (Republican budget, local budgets and the Social Protection Fund), there exist a variety of other important activities involving at least implicit government financial obligations. Thus, looking at the general budget can provide only a partial view of the fiscal picture. Given data limitations, it is very difficult to provide a complete picture, but even adding the information that is available can prove useful to understanding the overall fiscal balance and its sustainability.

2.10 *Extrabudgetary Funds.* In recent years Belarus has made some strides in incorporating extrabudgetary funds into the budget. In 1998, five previous extrabudgetary funds were included as earmarked targeted budgetary funds. Nevertheless, a variety of activities remain outside of the formal budget.

Box 2.1: Seigniorage and Inflation Tax Income in Belarus

With limited access to foreign financing, a poorly developed financial sector, and very limited privatization sales, the government has depended on the national bank for financing its deficits. In addition to national bank credits for deficit and off-budgetary finance, the government has made use of central bank profits for boosting fiscal revenues and recapitalizing state-owned commercial banks.

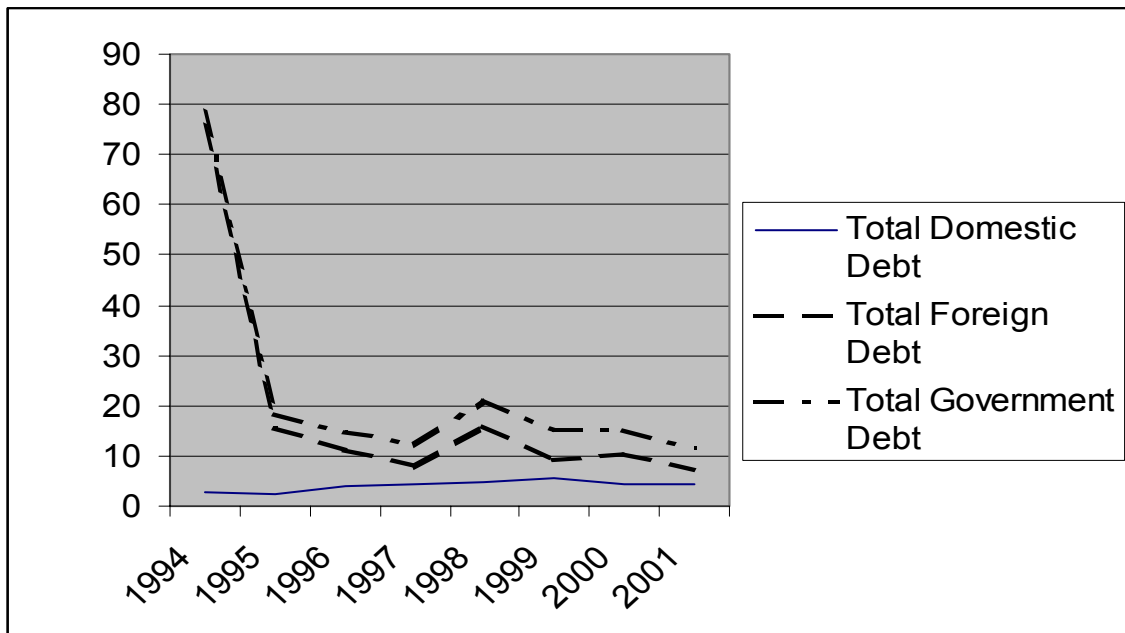
The NBB direct profit transfers to the budget have been relatively low, averaging 0.2 percent of GDP over 1998-2002, partly because the NBB has had to shoulder the responsibility for recapitalizing state-owned commercial banks (i.e., pay for what should be fiscal expenditure). Also, due to the NBB's weak net foreign asset position, NBB profits from the placement of excess reserves have been minimal.

The 2001-2003 Budget Laws contained explicit NBB Government deficit financing targets that were routinely exceeded when other budgeted sources of financing did not materialize. In 2001, the NBB created an equivalent of 1.2 percent of GDP in high powered money to finance the government's deficit. The original 2002 Budget Law required the NBB to provide the government with Rbl 152 billion in direct low-interest financing. The draft Budget Law amendments prepared in September 2002 added another Rbl 30 billion, for a total of Rbl 183 billion (0.7 percent of 2002 GDP) in direct NBB deficit financing in 2002. Although the use of the NBB printing facilities to finance the deficit and cut the real value of the government's outstanding debt has been gradually slowing, in 2003, under the budget signed by the president and sent to Parliament, the NBB will be required to add another Rbl 152 billion (0.5 percent of GDP) in high powered money to finance the projected 2003 deficit. (This financing is earmarked for housing construction.) As the NBB's foreign exchange position is expected to remain very weak and its other assets comprise low interest earning claims on the Belarus government and weak banks, the Government's projected receipts from NBB's profits in 2003, at Rbl 10 billion, will be lower in nominal terms than the projected 2002 outcome of Rbl 15.5 billion.

Money emission related to national bank financing of the government and (at least implicitly) the national economy has fuelled high and unstable inflation, which has cut into the wealth of the population and kept money demand weak. During 1998-2002, economic agents in Belarus held an equivalent of only 22 percent of GDP in various components of *broad money*, and the ratio fell to 16 percent in 2001-02. However, *foreign currency deposits* accounted for over 50 percent of the broad money and between 70 and 80 percent of all *time, savings and foreign currency deposits*. If foreign currency cash holdings are added (estimated by some at \$2 billion or Rbl 3.8 trillion at today's exchange rate) to broad money, it becomes clear that rubels may have accounted for less than 25 percent of all money stock in Belarus and foreign currency cash and deposits accounted for over 90 percent of all savings balances. The very low demand for rubels make even small NBB emission for deficit finance have a significant impact on inflation.

The inflation tax calculated as the reduction in real value of base money due to inflation, is estimated at 3.6 percent of GDP during 1998-2001. Inflation tax "receipts" were 5.1 percent of GDP in 1998, and gradually fell to 2.5 percent of GDP in 2001.

Figure 2.2: Domestic and Foreign Debt as Share of GDP



Sources: Ministry of Finance, NBB, IMF, and Bank staff estimates.

2.11 Among the largest remaining off-budget activities are the Innovation Funds controlled by individual ministries or other state bodies. Provision for the existence of such funds is stipulated by Article 41 of the Annual Budget Law for 2002. They are financed by levies at the rate of up to 0.25 percent from the costs of goods, works and services managed by legal entities (state-owned enterprises (SOEs) and other units with own-source income) subordinate to the Government of the Republic of Belarus. The Council of Ministers of the Republic of Belarus is granted the right to establish increased norms of allocations to innovation funds for certain republican state bodies and other state organizations subordinated to the Government of the Republic of Belarus. The innovation taxes, in particular their variable rates, distort the allocation of resources and the composition of final output. In 2001, revenues of innovations funds accounted for 2.0% of GDP. Expenditures were at approximately the same level (Table 2.3).

2.12 Every year, the government works out a special document for regulating the generation and disbursement of the Innovation Funds. Innovation Funds are particularly important for financing capital investments. Spending entities view the separation of the Innovation Funds from the budget as a way to maintain a minimum level of investments, as capital expenditures are typically among the first items sequestered from the budget in the case of cash shortages. This helps explain the continued existence of the Innovation Funds, despite the Ministry of Finance's support for their liquidation and the incorporation of an equivalent level of resources into the budget. This proposal is strongly opposed by line ministries and state organizations.

2.13 Other extrabudgetary items include funds of subordinate budget institutions generated by various user fees and other types of public receipts. Budget institutions are allowed to collect

and retain “own income” under a Cabinet of Ministers Resolution that regulates paid services that they may deliver. These resources may be used up to 40 percent on salary enhancements as well as other expenditures. An IMF Fiscal Affairs Department study estimated that the aggregate amount of such “own income” in 2001 was the equivalent of 6 percent of total public expenditure. While it has not been possible to obtain more recent data, Table 2.4 suggests that “own income” is an important source of revenues to some ministries, especially education and forestry. In 2000, own income of the ministries listed below was 0.5-7 percent of GDP ~~and there are no indications that it has been significantly reduced since that time~~. According to some sources, there also exists a substantial “President’s Fund” outside of the formal budget, although the government denies its existence and its size cannot be assessed.

Table 2.3: Revenues and Expenditures of Innovation Funds
(thousand rubels)

#	item	1999*		2000		2001	
		Revenues	Expenditures	Revenues	Expenditures	Revenues	Expenditures
1	Ministry of industry	8,405.50	8,382.80	24,445.00	24,391.00	42,181.70	41,981.30
2	Ministry of architecture and construction	250.1	241.9	4,397.00	4,233.00	11,985.10	11,854.20
3	Ministry of communication	5,582.00	5,595.00	15,359.00	15,398.00	36,195.00	36,178.00
4	Ministry of transportation and transportation links	967.7	596.4	1,859.00	1,203.00	3,571.00	1,678.00
5	Ministry of housing and communal services	23.6	20	77	62	165	133
6	Ministry of commerce	10.9	8.8	36.8	34	63	51.9
	Concerns						
7	Bellegprom	199.7	167.8	2,551.30	2,418.70	3,441.00	3,295.40
8	Belbiofarm	130.2	128.5	701	685	1,938.90	1,928.00
9	Bellesbumprom	651.6	603.6	668.9	660.6	889.3	841.3
10	Belmestprom	25.9	23	165.2	159.9	427.9	417.9
11	Belneftechim	1,251.50	1,068.00	11,605.90	10,373.70	45,371.00	43,096.00
12	Belenergo	26,165.70	24,151.70	63,417.70	56,760.20	95,383.60	89,270.40
13	Beltopgaz	12,252.40	8,765.30	29,479.20	31,825.40	47,570.30	47,448.00
14	Belkoopsouz	1,606.00	1,609.10	4,376.20	4,368.40	7,199.30	7,140.40
15	Belresursy	17.6	5.7	37.9	7	71.1	34.8
16	Public enterprise Beltransgaz**	-	-	-	-	22,149.90	20,911.70
17	State aircraft committee	719.8	681.3	1,290.00	1,097.00	5,129.00	3,173.00
18	Belarusan railway	794	568.7	12,792.00	11,246.00	30,898.00	29,609.00
19	Public assosiation Belbyt**	-	-	-	-	84.3	83.5
20	transportation links	14.6	12.7	22.2	10.9	65.9	62.7
	Total	59069	52630	173281	164934	354780	339189
	Memo: GDP	3,026,064	3,026,064	9,133,776	9,133,776	17,173,230	17,173,230
	Total Innovation Funds/GDP	2.0	1.7	1.9	1.8	2.1	2.0
	* revenues include carry-over residuals, for the year 1999 - adjusted to denomination						
	** innovation funds weren't formed						

Source: Ministry of Economy.

Table 2.4: Extrabudgetary Income of Selected First Level Institutions, ~~2000~~2002
(million rubels & percent)

Ministry/Institution	Financing from Budget	Extra-budgetary Income	Extra-budgetary/Budget Financing (%)
Science and Technology Committee	5010.4	332.7	6.2
Ministry of Education	159979.2	132942.4	45.4
Ministry of Health	198562.0	19282.8	8.9
Ministry of Forestry	71042.3	24060.2	25.3

Source: Ministry of Finance ~~and IMF data.~~

2.14 *Quasi-fiscal activities* . Activities carried out at the government’s request, but not paid for from explicit budgetary resources, are often termed quasi-fiscal operations. Conceptually, they properly belong to the category of public expenditure, and often imply social costs over and above an equivalent budgetary outlay. There are some activities that are routinely provided by the government outside of the budget, and these activities should be included in a comprehensive analysis to give a clearer picture of the true fiscal role of the government in the economy.

2.15 In Belarus, public utilities, state enterprises and commercial banks routinely shoulder obligations related to implicit expenditures of the government. For example, Belarusian banks are routinely “encouraged” to finance priority sectors and projects with soft credits (primarily in agriculture and housing construction). On a number of occasions, the NBB has performed a recapitalization of distressed banks out of its own resources, thereby paying for what would normally be a fiscal obligation of the government. The total quasi-fiscal cost of low-cost lending to agriculture has been estimated at 2.3 percent of GDP in 1999, while the quasi fiscal costs of housing loans were estimated at 0.5 percent of GDP in the same year.

2.16 Quasi-fiscal operations can be carried out under various disguises. For example, in 2002, the Belarusian government asked oil distributors to donate fuel for the harvest campaign. Also, industrial and agriculture companies continue to finance a large share of social assets (housing, utilities, schools), as inherited from the Soviet period, that should properly be the responsibility of municipalities (Table 2.5). Periodic “subotniki” (working Saturdays) announced by the government provide local municipalities with close to free labor for one day to clean parks and carry out various small projects. The value of the various social expenditures carried out by enterprises according to some kind of government mandate has been estimated at about 2.0 to 3.0 percent of GDP.

Table 2.5: Composition of Social Expenditures of Enterprises

Excluding Banks and Small Non-state Organizations and Taking into Account Denomination in 2000

	1998		1999		2000		2001	
	BRB m	% Total	BRB m	% Total	BRB m	% Total	BRB m	% Total
Expenditures of Social Development	12941	100.0	74583	100.0	201893	100.0	357608	100.0
Construction of Facilities	3435	27.5	29121	39.0	62577	31.0	82724	23.1
Maintenance of Facilities	8161	65.3	41982	56.3	128410	63.6	253870	71.0
Health, sports and social insurance	1813	14.5	9881	13.2	31323	15.5	64720	18.1
Education	2016	16.1	11563	15.5	36737	18.2	67602	18.9
Culture	322	2.6	1711	2.3	6429	3.2	13947	3.9
Housing and utilities	4010	32.1	18827	25.2	53921	26.7	107601	30.1
incl. departmental housing	2681	21.5	14450	19.4	41112	20.4	83245	23.3
Special Events	895	7.2	3480	4.7	10906	5.4	21014	5.9
Health and sports	634	5.1	1469	2.0	4768	2.4	8574	2.4
Education and culture	261	2.1	2011	2.7	6138	3.0	12440	3.5
Expenditures of Social Development as % GDP	1.8		2.5		2.2		2.1	

Sources: Belarus authorities and Bank staff estimates.

2.17 Before 2000, the use of multiple exchange rates supported various quasi-fiscal measures that provided cheap foreign currency and imports to selected firms and organizations. Fortunately, the government succeeded in eliminating this practice through the subsequent unification of the exchange rate.

2.18 *Other subsidies.* Other off-budget activities that have significant implications include various types of implicit import subsidies, consumer subsidies, and producer subsidies. Implicit import subsidies come from Russia in the form of low prices for natural gas. In 2001, Russia supplied natural gas to Belarus at a lower price than to other CIS importers, –on average \$31 per 1,000 m³ about a third of the world market price of about \$103 per 1,000 m³. With annual imports of about 17.3bn cubic meters in 2001, the resulting gross gas subsidy is estimated at about 10 percent of GDP. Part of this subsidy is retained by the Belarusian energy company, as it distributes gas at a higher price than it pays.

2.19 Despite some progress in liberalization and increases in regulated prices, selected price subsidies remain important in Belarus. For consumer goods, three main categories of goods and services were still subject to controls in 2001: socially important goods, a list of goods under “ministerial price controls,” and goods produced by 25 strategic enterprises.

2.20 The government has made some progress in the reduction of subsidies and cross-subsidies in utility pricing, but their levels remain high compared to most other transition countries. In January-December 2002 utility tariffs covered an estimated 37.1 percent of the costs of providing these services during the heating season and 31.1 percent during the summer season. Taking into account tariffs for gas and electricity during 2002, the cost coverage of utilities by the population reached 39.6 percent in the heating season and 36.4 percent in the summer season. These subsidies are financed largely through cross-subsidization, i.e. by charging industrial consumers higher prices. The authorities estimated (and reported to the IMF)

the value of cross-subsidies in the energy sector at (pre-2000 rubels) Rbl 24.6 trillion (3.6 percent of GDP) in 1998, Rbl 114 trillion (3.9 percent of GDP) in 1999, and (post-2000 denomination rubels) Rbl 279 billion (3.1 percent of GDP) in 2000, and about 3 percent of GDP in 2001.

2.21 Selected tax preferences and preferential customs treatment represent foregone revenue to the government, and can therefore also be treated conceptually as a type of quasi-fiscal expenditure. In 2000, tax exemptions granted on the basis of individual decisions of the president reached about 1 percent of GDP, of which customs duties were equivalent to 0.2 percent of GDP and VAT exemptions to 0.1 percent of GDP. These ad hoc exemptions do not include the more extensive privileges that are written into law and are estimated to amount to 2-3 percent of GDP.

2.22 In addition to price subsidies and exemptions, the selected enforcement of payment discipline is another type of quasi-fiscal activity. Domestic arrears on payments for energy reached an estimated 14.2 percent of GDP at end 2001, and this figure picked up to 17.3 percent in the first nine months of 2002, before falling to 13.4 percent of GDP at end 2002. Roughly half of energy arrears concern natural gas. Industrial enterprises are the largest debtors, followed by housing and communal services, and agricultural entities. The accumulation of domestic arrears has also led to the build-up of external energy arrears, despite the low prices paid on energy imports. As of October 1, 2002, these arrears amounted to Belarusian Rbl 493.3 bn or 2.7 percent of GDP (Rbl 322 bn or 1.3% GDP at end-2002). The Russian gas monopoly, Gazprom, has promised to enforce stricter payment discipline in years to come.

2.23 *Contingent liabilities.* In addition to the explicit and implicit costs that are discussed above, the Belarusian budget is also subject to a range of contingent liabilities. Contingent liabilities exist when the government is subjected to an obligation should a particular event occur. The right hand column of Table 2.6 sets out a variety of possible contingent liabilities. For example, the government provides a variety of guarantees to support both banks and the business sector – should a given entity fail to meet its obligation, the state will be required to step in. More broadly the government faces a substantial contingent liability should the banking system fail to meet its obligations. Some of these contingent liabilities and the risks they pose are discussed below.

2.24 The fiscal snapshot above illustrates that, while official data suggest that Belarus has a low deficit and relatively low debt ratios, the underlying fiscal position is much more serious. When one looks a little deeper into those items that remain off-budget, the extent of quasi-fiscal deficits, and the level of contingent liabilities, it becomes clear that Belarus is in need of significant fiscal adjustment. Indeed, although general government expenditure was just less than half of GDP in 2001, the considerations above suggest the true level of government expenditures is much higher.

Table 2.6: Government Fiscal Risk Matrix

<i>Sources of Obligations</i>	<i>Direct Liabilities (Obligations in any event)</i>	<i>Contingent Liabilities (Obligation if a particular event occurs)</i>
<p><i>Explicit</i></p> <p>Government Liability as recognized by a law or contract</p>	<ul style="list-style-type: none"> -Sovereign debt (loans contracted and securities issued by central government) -Expenditure composition (non-discretionary spending) -Expenditure legally binding in the long term (civil service salaries and pensions) 	<ul style="list-style-type: none"> -State guarantees for non-sovereign borrowing by and other obligations of subnational governments and the public and private sector - Umbrella state guarantees for various types of loans (mortgage loans, student loans, agricultural loans, small business loans) - Trade and exchange rate guarantees issued by the state - State guarantees on private investment - State insurance schemes (deposit insurance, income from private pension funds, crop insurance, flood insurance)
<p><i>Implicit</i></p> <p>A moral obligation of government that reflects public and interest group pressures</p>	<ul style="list-style-type: none"> -Future public pensions (as opposed to civil service pensions)^a -Social Security schemes^a -Future health care financing^a - Future recurrent costs of public investment projects <p>^(a)In this framework, these services fall in the category of direct implicit liabilities if their provision is not mandated by law. If mandated by law, then these services fall in the category of direct explicit liabilities.)</p>	<ul style="list-style-type: none"> - Default of subnational government or public/private entity on non-guaranteed debt/obligations - Banking failure (support beyond government insurance, if any) - Cleanup of liabilities of entities being privatized -failure of non-guaranteed pension fund, employment fund or social security fund - Possibly negative net worth and/or default of central bank and its obligations (foreign exchange contracts, currency defense, balance of payments) -Other calls for bailouts - Environmental recovery, disaster relief, military financing

Source: Polackova, Hana, 1998, "Contingent Government Liabilities: A Hidden Risk for Fiscal Stability", Policy Research Working Paper 1989, World Bank, Washington, D.C.

Low Deficits and Debt Levels Mask Several Problems

2.25 The low debt-to-GDP and interest payments-to-government revenue ratios set out above provide only very limited comfort to policy makers. In a very stable world, the fiscal stance of the Belarus government may be deemed sustainable, at least in the short-term. However, as the economy is subjected to internal and external shocks, the resulting change in the fiscal stance could be rendered unsustainable, and insolvency or default could result despite initial stability and the low debt level.

2.26 In the case of Belarus, the low debt ratios may be a sign of economic fragility as much as one of prudent macroeconomic management and financial strength.² Although the absolute level of government debt is low relative to GDP, the economic financing costs are not negligible.³ The debt servicing costs are bound to increase rapidly in the near term, as the government is forced to pay high market interest rates in the domestic debt market and its access to inflationary central bank financing is curtailed.

2.27 The public sector's liquidity position is precariously low and the liquidity position of the banking sector is very weak. The Belarusian government and the Belarus National Bank (NBB) have at their disposal only very limited resources to counter financial pressure or outright crisis. The central bank's international reserves are extremely low (at just 2-3 weeks of imports, compared to a desirable absolute minimum of at least 3 months) (Figure 2.3); and the public enterprise sector is illiquid, as it cannot sell its output and often resorts to barter and runs tax arrears. The very weak and illiquid balance sheet of the enterprise sector makes crisis even more likely, because it destabilizes the government's revenues and undermines the government's ability to pay its own debts.

2.28 Ministry of Finance (MoF) treasury deposits in rubels and foreign currencies plummeted from Rbl 127 billion (U.S.\$ 80 million) at the end of 2001 to Rbl 84 billion (U.S. 45.9 million) on July 31, 2002. Deposits of the government, its agencies and the budgetary and extrabudgetary funds all fell and remained extremely low by international standards. Total government deposits with the banking system covered less than two weeks of general government expenditure, and tax and expenditure arrears have increased, although public sector wages and pensions continue to be paid more or less on time. The reserves of the Social Protection Fund (SPF) have declined from about 82 percent of monthly outlays in January 2001 to just 6 percent in April 2002, despite a massive infusion of funds to the SPF from the central government budget in April-May.⁴ Not surprisingly, the government is systematically forced to accumulate payment arrears to public utilities for services to public institutions (Table 2.7). In recent months, teachers' salaries and pension payments were also running behind schedule. The accumulation of payment arrears is

² In fact, the Belarusian internally imposed ceiling on foreign government debt stands at \$2 billion, more than two times the current amount of foreign debt.

³ In 2001, the interest expenses on government debt amounted to 0.7 percent of GDP. However, since the government has no access to foreign financing, it had to repay (on a net basis) an equivalent of 0.1 percent of GDP. In the first six months of 2002, the government had to divert for foreign debt amortization 0.4 percent of GDP, even though it budgeted receiving 0.6 percent of GDP in new foreign financing in 2002.

⁴ After drawing down all its deposits carried over from 2001, the SPF received in April-May not only its entire annual budget allocation from the central government budget, but also a short-term loan.

likely to create pressure for mutual offsets of those against tax arrears. Thus far, the volume of offset arrangements has been fairly small (about 5 percent of government expenditures in most years). But as budget constraints are tightened (including following the planned currency union with Russia), there may be greater pressure to resort to netting and offsets. The experience of Russia, Ukraine and other CIS countries suggests this should be avoided.⁵

Table 2.7. Government Expenditure Arrears
(in billions of rubels)

	1-Jan-02	1-Apr-02	1-Aug-02
Total	312.6	407.2	404.4
o/w:			
central gov.	129.9	120.0	120.0
local gov.	182.7	287.2	284.4
o/w:			
Payment for goods and services	211.8	303.8	308.5
o/w municipal services	114.0	187.8	185.4
Subsidies	34.7	37.6	39.4
Transfers to population	32.1	39.9	21.9
Capital goods	34.0	25.9	34.6

Source: Ministry of Finance.

2.29 A new agreement with Russian gas supplier, Gazprom, promises to place a further strain on the liquidity of the government. While more than 90 per cent of all payments for Russian gas have been in the form of barter, Gazprom is demanding cash or cash equivalents in the future as a precondition for continuing to supply a substantial quantity of natural gas (10.2 billion cubic meters) to Belarus at the subsidized internal Russian price in 2003.

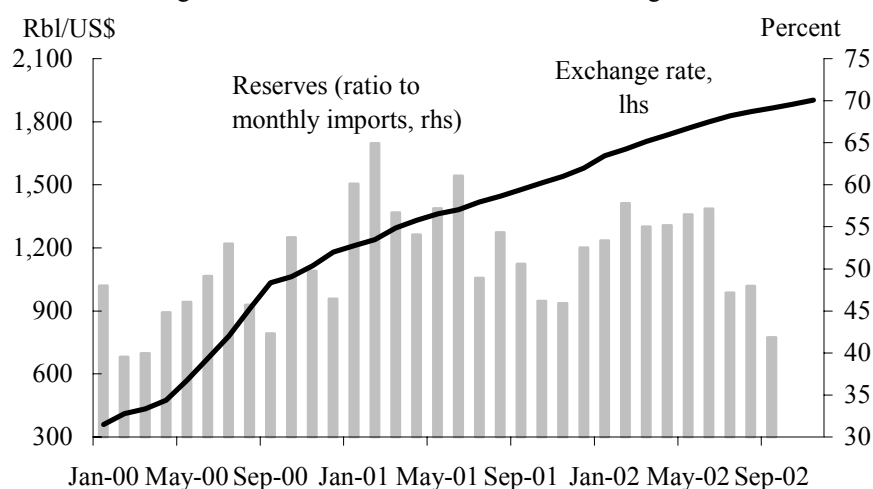
2.30 The Belarus government and its financial institutions have very limited access to international financial markets. Even access to domestic sources of financing is extremely restricted. ~~The MoF, unable to sell its debt at competitive auctions, routinely resorts to direct placements and “after auction sales,” with the private placements becoming increasingly the main source of financing. During January 1-July 11, 2002 the MoF resorted to selling its securities directly to selected investors 37 times and placed this way Rbl 180 billion worth of securities (at face value). Typical “free” auctions often attracted no buyers or one or two buyers for just 10 percent of the auction offer.⁶ Not surprisingly, the government routinely has resorted to rolling over and re-scheduling its debts, including its foreign currency debt sold in Russia. For example, two bond issues for US\$25 million each falling due on May 30, 2001 and July 31, 2001~~

⁵ For example, in Russia offsets undermined the Federal Government tax base, contributing to the 1998 crisis.

⁶ After three unsuccessful auctions on April 16 and 23, when out of a total nominal offer of Rbl 20 billion only Rbl 0.65 billion was sold, the Government had little choice but to resort to direct placements to sell Rbl 38.6 billion worth of securities (nominal value) between April 23 and May 2. The largest placement, for Rbl 15.7 billion on April 25, had a maturity of just 18 days, and the two placements on May 2 offered maturities of 18 and 21 days. On May 13 the MoF apparently averted an imminent crisis by rolling over the maturing debt into three direct placements with maturities of 168, 218, and 225 days. The MoF’s quite desperate financing situation can also be explained by the withdrawal from the market of the NBB. In late 2001, the NBB participated in most auctions. This practice has apparently been stopped, or at least suspended, during January-July 2002.

~~were re-scheduled for repayment in 2002. In another example, in the first quarter of 2002 the government rolled over some of its outstanding bills to limit new issue. Also, though relatively small in relation to GDP and government revenues, Belarus government debt is characterized by extremely short maturity. In this respect, Belarus remains extremely vulnerable to short-term volatilities in financial markets.~~

Figure 2.3. International Reserves and Exchange Rate



Source: NBB, IMF Staff calculations.

~~2.31 Also, though relatively small in relation to GDP and government revenues, Belarus government debt is characterized by extremely short maturity. The bulk of treasury bills outstanding at any moment mature in less than one year, and the situation has become even more difficult in 2002, when in May the government started experimenting with maturities as short as 14 days. In this respect, Belarus remains extremely vulnerable to short term volatilities in financial markets.~~

2.3231 At the same time, additional sources of revenue are also quite limited. As seen above, the government already collects a significant share of national income in taxes and fees and any further expansion of tax receipts will be difficult to accomplish without risking difficulties in the enterprise sector and the spread of tax evasion among households and the nascent private sector. The potential source of additional revenues from privatization of state enterprises is limited, as the estimated value of gross assets in Belarus appears to have shrunk significantly in the past decade.

Issues in Medium-Term Fiscal Sustainability

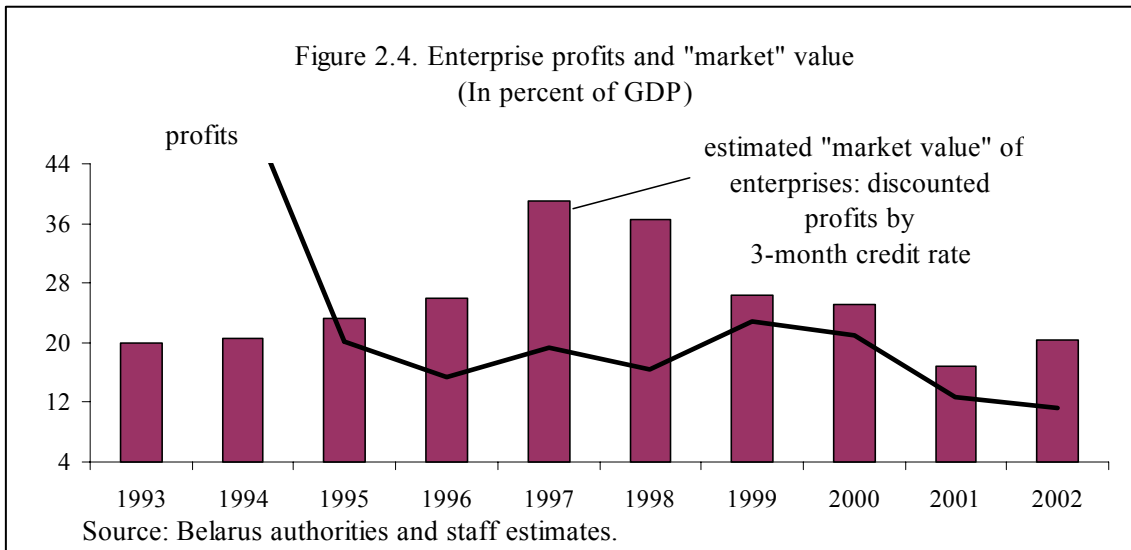
2.3332 The difficult liquidity position of the Belarus government, combined with the wider potential claims on the government that are currently unaccounted for in the official budget, suggest significant risks to the government's fiscal position. The prospect of lower gas subsidies from Russia, and the need to pay for Russian gas with cash equivalents promises to further

complicate an already difficult situation. Government tax receipts are not expected to rise over the medium-term. On the contrary, the already enormous burden of taxation and other regulations on Belarusian firms appears to be hindering their ability to compete with their counterparts in Russia, Ukraine, and other transition countries, further feeding into lower profits, liquidity, and, consequently, tax payments. On the expenditure side, assuming financing constraints continue to limit the deficit, the government's commitment to achieve prescribed wage targets will further undermine capital and infrastructure spending. As shown in Table 2.8, the government's wage policy will continue to crowd out public capital investment from 10.7 percent of GDP in 1999 to 2.2 percent in 2008.⁷ A number of other issues pose serious risks in the medium term.

2.3433 *Deteriorating enterprise profitability bodes ill for future revenues and the public sector's net worth.* The government's policy of real wage increases -- as outlined in the five year plan approved in 2001 (see Chapter III)-- even if compensated by the growth of utility tariffs and partial liberalization of prices, could likely result in macroeconomic imbalances due to improper sequencing. Usually, the growth of labor and capital productivity due to microeconomic restructuring and market incentives result in improvement of enterprise profitability, which then allows for an increase in compensation of employees. The opposite sequencing could further undermine the profitability of enterprises.

2.352.34 The profitability of the enterprise sector in Belarus has recently declined notably (Figure 2.4). As Russia, Ukraine, and other transition countries continue to improve the climate in their countries for business and investment, and domestic production in these countries picks up, many Belarusian firms are finding it harder to compete. The profits of enterprises as a share of GDP declined to 10-11 percent of GDP in 2001, from above 30 percent of GDP ten years ago, and continued to decline rapidly in the first quarter of 2002. The stock of inventories of finished products rose from over 50 percent of production in late 2000 to close to 70 percent in the first quarter of 2002 (Figure 2.5); the number of loss-making enterprises increased to 34 percent in the fourth quarter of 2001 and a staggering 44.1 percent during the first quarter of 2002, while the economy-wide profitability of output fell to 5.1 percent in January 2002 before recovering somewhat to 7.4 percent for the entire first quarter of 2002, down from 9.8 percent in the same period of 2001, and 15.2 percent in 1999. The value of losses amounted to an equivalent of 2.2 percent of GDP in 2001.

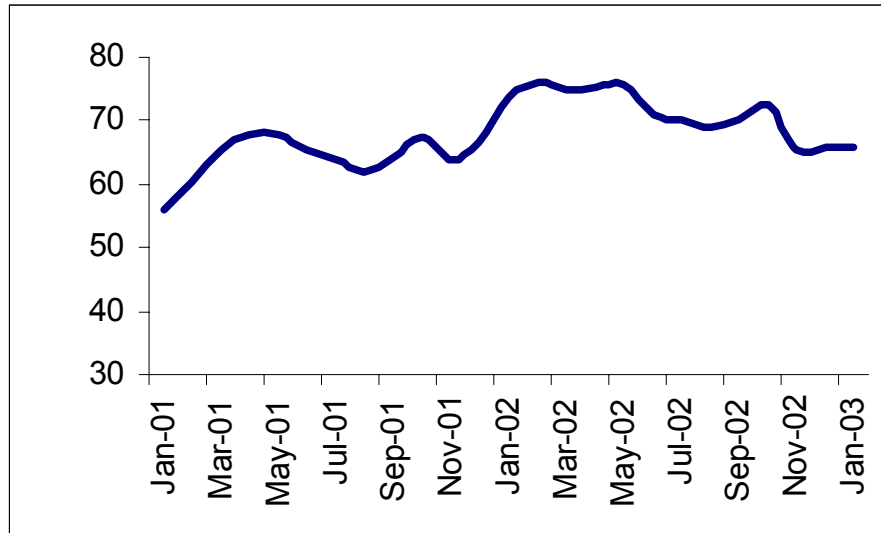
⁷ The projections of the medium-term horizon in Table 2.8 are based on the general budget number and do not take into account the wide variety of off-budget and quasi-fiscal activities discussed in the previous section. Creating a medium term analysis that accurately captures all off-budget and quasi fiscal activities, is beyond the scope of this study. The collection of systematic information and preparation of a framework for incorporating these into budget accounts is an important recommendation of this study.



2.3635 In addition, the depreciation of enterprise capital reached over 60 percent and much of the capital stock was obsolete and uncompetitive in international markets. Market-oriented reforms aimed at improving economic efficiency at the enterprise level will inevitably result in a growth of loss-making enterprises as subsidization is phased out and harder budget constraints are put in place.

2.3736 *Enterprise debts are mounting.* Although overall government debt as a share of GDP remains relatively low, the balance sheet of the broadly defined public sector is very weak and rapidly deteriorating. Belarus state enterprises are not only less and less profitable, and more and more of them actually lose money, but also their balance sheet net worth is rapidly declining. According to the official data, as of April 1, 2002, the gross liabilities of Belarus enterprises were valued at Rbl 9.4 trillion (close to 50 percent of GDP). Of this amount, almost half (Rbl 4.5 trillion) was overdue, of which 67 percent was overdue by 3 months or more. Foreign liabilities of Belarus enterprises amounted to Rbl 1.49 trillion (about 7.5 percent of GDP) on April 1, up from 1.39 on January 1, 2002, of which Rbl 847 billion was owed to Russian companies. The net liabilities to nonresidents (the difference between liabilities and claims on nonresidents) amounted to Rbl 811.9 billion or about 4 percent of GDP. The rapid growth in debt, especially in the "overdue" debt category, is very worrying, in particular given the very low level of international reserves.

**Figure 2.5 Inventories of finished goods
(In percent of monthly industrial production)**



2.3837 *Energy subsidies from Russia are not likely to last long.* The Belarusian economy has benefited from significant indirect subsidies from Russia in the form of relatively cheap gas supplies, and the ability to pay for its imports from Russia and some other CIS countries directly in its own exports through barter arrangements. Low-cost gas imports and barter payments relieved some of the pressure from the government to increase direct and indirect subsidies to domestic producers and households. The agreements signed this past summer with Russia provided temporary relief in the form of low prices for gas, as Belarus pays Russia's domestic price for gas imports from Gazprom (almost 2/3 of imports of gas). Tensions mounted in toward the end of 2002, however, as payment arrears for natural gas continued to increase. Under new arrangements, Belarus will have to pay a higher price for gas consumed over a limit from Gazprom of 10.2 billion kw in both 2002 and 2003. Furthermore, as a condition for continued subsidization, Gazprom is demanding cash or cash equivalents and an end to non-payments. The progressive increase of Russian domestic gas prices will also automatically carry over to Belarus. A rapid increase in Russia's domestic price paid by Belarus to the level of US\$50 per 1000 cubic meters, or about half the price in Western Europe would require an estimated 3.6 percent of GDP in additional balance of payments financing. A full deregulation that would bring the internal price of gas to about \$100 per 1000 cubic meters would likely trigger a massive economic crisis, as Belarus would need to spend more than 10 percent of its GDP (or more than three times its today's cost) on gas imports.

Table 2.8: Belarus: Fiscal Indicators and Projections, 1999-2008

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
				Prel	Proj		Medium-term proj.			
<i>(In percent of GDP)</i>										
1. State (Republican and local) budget										
Revenue	34.8	34.7	33.4	32.2	32.4	32.1	31.8	31.5	31.2	30.9
Expenditure (cash)	37.8	35.4	35.1	34.0	33.3	32.3	32.1	31.9	31.6	31.3
o/w transfer to the SPF	0.3	0.1	0.0	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Expenditure (accrual basis 1/)	...	...	36.3	34.1	35.7	35.3	35.0	34.6	34.3	34.0
Balance (cash)	0.0	0.0	-1.7	-1.9	-0.9	-0.2	-0.3	-0.4	-0.4	-0.4
Balance (accrual 1/)	...	...	-2.9	-1.9	-3.2	-3.2	-3.2	-3.2	-3.1	-3.1
2. Social Protection Fund										
Revenue	10.8	11.1	11.6	12.0	12.0	11.8	11.7	11.6	11.5	11.4
o/w: transfers from the Rep. Budget	0.3	0.1	0.0	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Expenditure	9.8	10.5	11.8	12.0	12.8	12.6	12.5	12.4	12.3	12.1
Balance (cash)	1.0	0.5	-0.2	0.0	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
3. General government										
Revenue	45.6	45.7	44.9	43.9	44.0	43.5	43.1	42.7	42.3	41.9
Expenditure (cash)	47.3	45.8	46.8	45.7	45.6	44.5	44.2	43.9	43.5	43.0
Non-interest payment expenditure (cash)	46.6	45.0	46.1	45.1	45.2	44.1	43.8	43.6	43.2	42.7
Wages and Salaries	7.3	7.6	7.4	..	6.0	6.3	6.5	6.5	6.5	6.5
Capital Expenditure	10.7	8.3	6.5	..	3.3	2.7	2.4	2.4	2.3	2.2
Expenditure (accrual basis 1/)	...	...	48.1	45.8	48.0	47.5	47.1	46.6	46.2	45.7
Balance (cash)	-1.7	-0.1	-1.9	-1.9	-1.7	-0.9	-1.1	-1.2	-1.2	-1.2
Balance (accrual 1/)	...	...	-3.1	-2.0	-4.0	-4.0	-4.0	-3.9	-3.9	-3.8
Statistical discrepancy	-0.1	-0.7	-0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
4. Financing (cash), o/w										
Privatization	1.8	0.8	1.7	2.0	1.7	0.9	1.1	1.2	1.2	1.2
Foreign financing, net	0.1	0.1	0.1	1.7	0.3	0.3	0.3	0.3	0.4	0.4
Domestic financing, net	-0.1	-0.5	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Domestic financing, net	1.8	1.3	1.5	0.2	1.3	0.5	0.6	0.6	0.6	0.6
Memorandum items:										
Changes in arrears	0.0	0.8	1.2	0.1	2.4	3.1	2.9	2.8	2.7	2.7
GDP (trillion of rubels)	3.0	9.1	17.2	25.2	34.1	41.4	46.9	51.2	54.5	57.6
Real GDP growth rate	3.4	5.9	4.7	4.7	3.5	2.5	1.5	2.0	2.0	2.0
Average CPI	294.0	168.9	61.3	42.5	29.2	18.3	11.8	6.9	4.5	3.5
Stock of expenditure arrears	0.1	1.1	1.8	1.3	4.2	3.1	5.6	7.9	10.1	12.3

Source: Ministry of Finance, SPF, and IMF staff estimates.

1/ Includes changes in arrears.

2.3938 *Vulnerabilities in the banking system may grow.* The rapidly declining competitiveness of the corporate sector is fully reflected in the Belarus banking sector. According to official data, non-performing loans in the banking sector accounted for at least 2 percent of GDP in 2001. The planned improvement in bank loan classification methodology and the restructuring of enterprises are likely to push this ratio much higher. Should non-performing bank assets double or triple --a quite likely scenario following economic opening to competitive pressures from Russia -- bank re-capitalization would put a significant burden on public finances in an environment of high interest rates. The interest rate expenditure to cover the additional debt to restructure banks would inevitably crowd-out other public expenditure, such as social transfers and infrastructure investments.

2.4039 The large share of loss-making enterprises bodes ill for the ability of banks to collect debts, especially after the inflation rate declines sharply in response to policies oriented at economic stabilization and following the possible introduction of the Russian ruble. Belarus banks also face a daunting task of ensuring credible levels of asset coverage for their foreign-currency denominate liabilities.

2.4140 *The government's current action plan is unlikely to bring long-lasting results.* In response to the mounting problems in the enterprise sector that threaten medium-term fiscal sustainability, the government has prepared a Program to Improve the Financial Condition of the Non-financial Enterprise Sector.⁸ Although the Program document provides a sound evaluation of the major impediments to enterprise competitiveness, profitability, and general financial recovery, the Program's goals and objectives, indicate that the authorities' main objective is not so much to improve the financial condition of the enterprise sector, but rather, to "improve the financial-economic *indicators* of the enterprises." As a result, most measures are indicators-oriented. Specifically, the authorities seek improvements in the financial-economic indicators primarily through short-term, mostly administrative, measures, such as: (i) elimination of over-normative inventories; (ii) reduction of energy prices to selective, energy-intensive enterprises; (iii) settlement of past-due obligations through a combination of debt restructuring, offsets (in particular, vis-à-vis the various levels of the government), provision of new credits to finance working capital needs; and (iv) implementing energy and raw materials-saving modern technologies and increasing the discipline during the implementation of the various administrative norms and regulations to reduce the production and marketing costs.

2.4241 The Program indicates that the authorities expect that most of the immediate improvement in the "indicators" will come from cuts in taxes and fees, sales of excess inventories (made possible by the extension of the Council of Ministers Resolution No. 259 to strengthen the position of Belarus enterprises in the domestic market), debt restructuring, and new bank directed lending.

2.4342 The Program, unfortunately, is silent on how to re-ignite "entrepreneurial development" and improve the "low level of financial management and marketing," or "administrative price regulations" (although, the list of goods and services subject to price controls is to be gradually shortened over 2002-2003), despite the identification of these as major causes of the "grave financial condition of enterprises" in the first section of the Program.

A Long-term Problem with Immediate Consequences: The Pension System

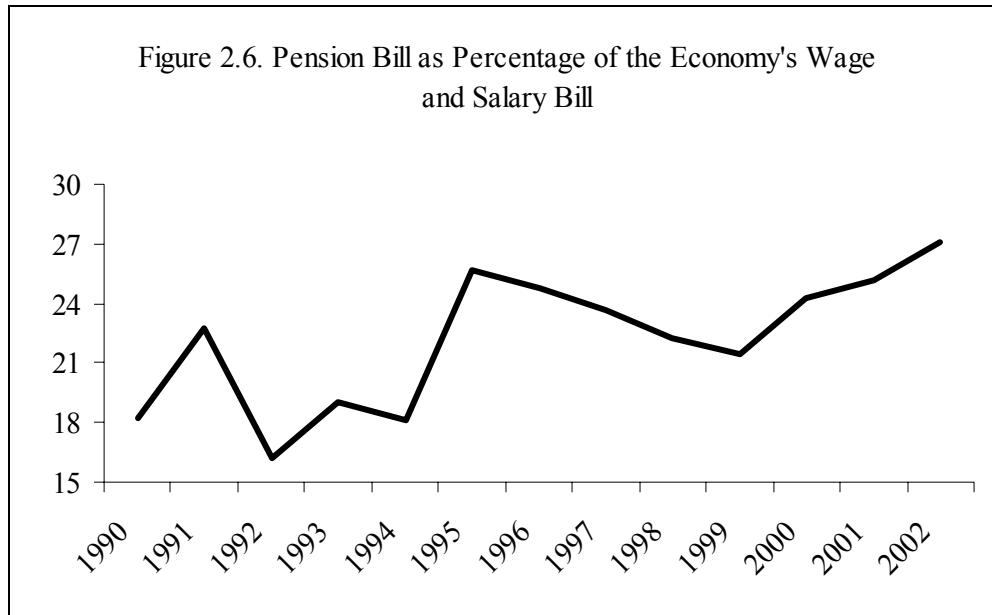
⁸ Adopted by the Council of Ministers on April, 15, 2002

2.4443 One area where the government is facing a major fiscal challenge is the state pension system. The Belarus pension system is financed on a pay-as-you-go (PAYGO) basis. Under the PAYGO system, social insurance taxes paid by current workers finance the benefits of current retirees. In the past, before the government's new wage policy came into force, the pension system's cash flow remained positive and pension fund tax receipts were partly used to pay some other, non-pension, benefits, such as benefits for families with children. However, since 2001 the finances of the system have come under strain. The sharp administrative wage increases put in place over the course of 2001 pushed pensions higher, while undermining corporate cash flows, profitability, and the ability of the corporate sector to make the required pension fund contributions. As a result, by the end of the first quarter of 2002, the Social Protection Fund (SPF) has exhausted its entire ~~accumulated from previous years~~ surplus that accumulated from previous years and the Republican budget had to transfer funds to the SPF to minimize pension arrears.

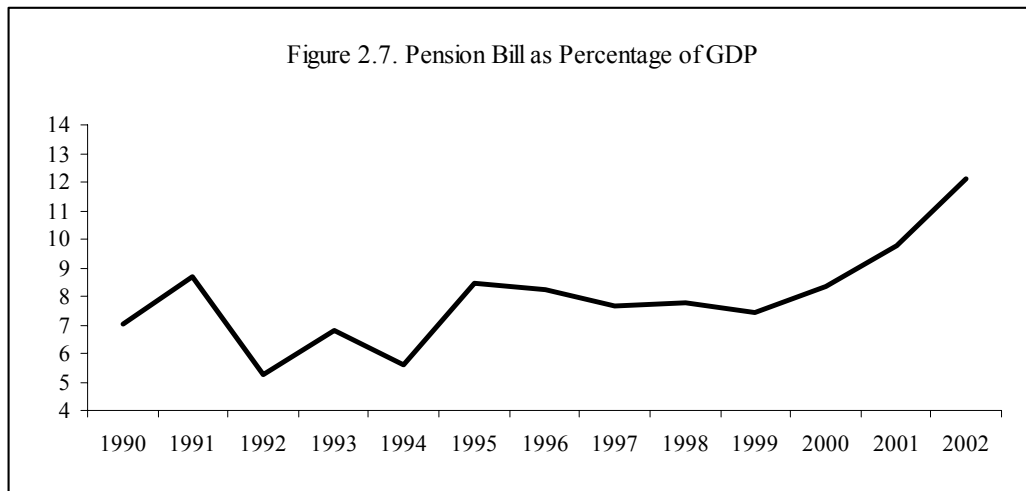
~~2.4544 As in other countries in the region, the~~ Deteriorating demographics and ~~—a shrinking reduction in labor force, similar to most other countries of the region, combined with~~ and pension arrears and the use of the pension fund for non-pension related benefits have been the primary source of troubles for the pension system. ~~system to reduce labor supply and provide social assistance to the poor and unemployed in the aftermath of the deep economic recessions in early 1990s non insurance payments, and arrears of corporate sector are at the root of the pension system's troubles.~~ The combination of demographic and economic developments in the past decade have pushed the number of workers supporting each pensioner from about 2.2 in 1990 to less than 1.7 today. However, in the case of Belarus, the severity of the problem may increase significantly by the rapid increase in pension benefits that are linked to wage levels and the weakness of the corporate sector overburdened with too many employees being ~~paid administratively (instead of productivity) determined wages protected by~~ the administrative guarantees of employment and labor remuneration.

~~2.462.45~~ Notwithstanding the demographic factors, the SPF's finances would have been in much better shape had it not been for the rapid increase in the pension benefits vis-à-vis labor income. The average pension in Belarus has risen from 32.5 percent of the average wage and salary in 1994 to almost 42.8 percent in 2001, before declining to 41.6% in 2002. By 2001, the aggregate pension bill had risen to over 25% of the average wage and salary bill (Figure 2.6).

2.4746 Not surprisingly, the combination of demographic developments and the relatively strong growth in the average pension have imposed ever rising burden on the SPF, public finances, and the economy. The estimated pension bill rose from 18.1 percent of the economies estimated wage and salary bill in 1994 to 27 percent in the first quarter of 2002. As a share of GDP, the pension bill jumped from just 5.6 percent in 1994 to 12.1 percent in the first quarter of 2002 (Figure 2.7).



Sources: Ministry of Finance, IMF, and Bank staff estimates.



Sources: Ministry of Finance, IMF, and Bank staff estimates.

2.4847 The pressure of the above factors on the daily cash flow of the SPF had been fully evidenced by the rapid decline of the SPF's reserves in 2002, and the emergence of periodic delays in pension payments, as discussed in more detail in Box 2.2.

Box 2.2: Social Protection Fund Finances in 2002-2003

Social Protection Fund (SPF) finances are being hurt by the increase in pensions benefits and by the growth of social tax arrears, both of which were triggered by the administrative wage increases in 2001. The SPF carried forward into the first quarter of 2002 Rbl 46.7 billion in savings from the previous years. These accumulated balances held in interest earning deposits earned the SPF Rbl 2 billion in the first quarter. However, by the end of the first quarter, the SPF reported a negative net cash position of Rbl 29.3 billion, as its cash flow recorded a deficit of Rbl 75.9 billion during the first three months of 2002. SPF's reserves amounted to 82 percent of monthly expenditures as of January 1, 2001, 20 percent on January 1, 2002 and just 6 percent on April 1, 2002.

SPF's ability to make pension and benefit payments in 2002 was preserved only through two extraordinary measures: (1) An immediate infusion of Rbl 76.5 (Rbl 66.5 billion in transfers and an Rbl 10 billion loan) from the Republican government budget and (2) a delay, until November 1, of pension indexation—~~that effectively meant the government reneged on its commitment to tie pensions to wages.~~

On the revenue side, social tax contribution arrears have increased to Rbl 118.5 billion on May 1, 2002, or by Rbl 30 billion during the first four months. It is unlikely the corporate sector could have delivered all the contributions required by law following the administrative wage increases in 2001 without resorting to borrowing. The government tried to rescue the SPF by requiring that all bank loans to enterprises for wage payments include adequate funding to cover the related social security contributions.

On the expenditure side, the SPF finances were undermined in 2002 by a recalculation of pension benefits in February that led to a 20 percent increase of average monthly pensions. This added expenditures of Rbl 34 billion per month (to a total of Rbl 203 billion ~~for the year per month~~). The indexation rules required pension benefits to be adjusted for average wage growth. But after nominal wages increased by 10 percent, the government was compelled to amend these rules. As a result, pension indexation was pushed back until November 1 despite the fact that CPI rose by 19.2 percent between end-January and end-October, and the frequency of indexation was moved to no more than four times a year.

The authorities' projections of SPF flows in 2002 and their budget plans for 2003 are likely to be overly rosy for at least three reasons:

- Strong revenue growth stems from the assumption that the high share of the wage bill in the economy (at 39 percent in 2001, up from 32 percent in 1997) can be maintained in 2002 and 2003. In reality, the nominal wage growth needs to slow down significantly for the corporate sector to return to profitability.
- It is unlikely that employers would be able to pay the full amount of social taxes due on higher wages. Falling corporate profitability makes further growth in social tax arrears in the remainder of 2002 and in 2003 almost certain.
- Pension spending is still overly tied to the growth in the average wage. Pensions still will be adjusted to wages, albeit more cautiously.. Therefore, any further wage growth will fuel growth in pensions. This will undermine both employment and the employers' ability to pay payroll taxes.
- Further gains in tax compliance will be difficult to accomplish. The ratio of social tax revenues to theoretical tax liability (based on average employment, compensation, and 36 percent tax rate) has already increased from an estimated 80 percent in 1998-99 to about 85 percent in 2001, and may in fact be difficult to maintain.

Box 2.2: Social Protection Fund Finances in 2002-2003 (Continued)

The authorities readily acknowledge in their 2003 SPF budget projections the growing gap between revenues and expenditure. The SPF projects that it will need Rbl ~~308-261.8~~ billion in transfers from the Republican Budget to support its cash flow in 2003. However, at the same time, the SPF tax revenue projections for 2003 seem very optimistic. Tax revenues are expected to grow by 42 percent in nominal terms, a figure that is somewhat high, given even the government's own optimistic growth projection of 6 percent and inflation forecast of 18-25 percent. IMF staff projects that in 2003 the SPF deficit could reach Rbl 251 billion, or 0.8 percent of GDP.

Recommendations for Addressing Fiscal Risks

~~2.49~~48 When Belarus' full fiscal picture is taken into account, it is clear that the economy is subject to significant fiscal risks. Some of these exist as the result of "sins of omission" – activities that have a significant bearing on government activity and the budget, but are excluded from any sort of formal presentation. Other items represent substantial vulnerabilities in the economy that ultimately may come to rest at the feet of the Government. These include: severe weaknesses in the state enterprise sector, the potential for a significant reduction in the energy subsidies from Russia, deterioration in the health of the banking system and mounting problems with the pension system.

~~2.50~~49 While addressing these vulnerabilities will likely go well beyond the budget, it is critical for the government to recognize that the large role of government and wide range of quasi-fiscal activities carried out by the government are at the root of the issues that have been identified in this chapter. Without addressing the size and nature of government's activities (both explicit and implicit) it is unlikely that these risks will be successfully addressed. The question to be addressed here is what measures either pertaining directly to the budget, or that have a significant impact on the budget, might be taken to address the risks in the system. They include the following:

~~2.51~~50 *Establish complete information on all fiscal risks in a comprehensive framework.* It is impossible to address fiscal risks if the government does not have a framework and clear picture of the totality of fiscal risks. This involves a number of steps:

- Extend the coverage of government accounts to include all government activities. This includes incorporation of the power ministries currently not covered in the budget, Innovation Funds, "own funds of ministries" and quasi fiscal deficits. Many of the items are currently reported to the Ministry of Finance or available to the NBB. Not including them in the budget makes it impossible to get a complete picture of the fiscal situation and fiscal risks.
- Benefits provided through tax exemptions and other allowances should also be included as an annex to the budget. Monitor and remove all tax exemptions provided by presidential decree. Monitor closely the operation of tax free zones and limit their growth.
- Develop a comprehensive framework for monitoring of all aspects of direct and contingent liabilities. This includes debt, debt guarantees, other types of guarantees and the potential costs of implicit liabilities such as the recapitalization of the banking system.
- Develop and publish a comprehensive balance sheet for the government, which measures the net worth of the government as well as the state-owned enterprises.

2.5251 *The Government should carefully consider its financing, lending and guarantee practices.*

- Beginning with the 2003 fiscal year severely limit (ideally discontinue) the practice of using NBB emission credits to finance government deficit, government programs (such as the housing program), or for recapitalizing the commercial banks.
- Discontinue all government lending that is denominated in currencies other than the rubel.
- Review and discontinue the practice of extending government guarantees on loans to enterprises, especially on loans in foreign currency.
- Discontinue the policy of directing banks to grant credits to enterprises.
- Refrain from all netting/offset arrangements.

2.5352 *Measures should be taken now to begin to prepare for the reduction in gas subsidies:*

- Accelerate the implementation of the program for the elimination of cross-subsidization.
- Develop a unified methodology for determining utility tariffs (in particular for gas, electricity, and water) to all users at levels justified by the full production costs and market conditions. Discontinue the current practice of granting selective price discounts to strategically important enterprises to boost their profitability.

2.5453 *Action should also be taken to support enterprises that are potentially viable:*

- Discontinue the practice of requiring enterprises to contribute various resources (financial and in-kind) to the annual harvest and similar programs, as discussed in par.2.17).
- Strengthen implementation of bankruptcy procedures to ensure that nonviable enterprises do not interfere or compete for resources with firms that are financially healthy.
- Accelerate privatization and eliminate all impediments to privatization, investment, and foreign capital flows, such as the “Golden Share.”

2.5554 *Addressing pension reform will also be key to Belarus' fiscal sustainability:*

- Re-evaluate the pension indexation rules to assure they are appropriate in the current economic climate.
- Prepare a comprehensive reform program to limit the growth in the number of pensioners and tighten conditions for eligibility, with the goal of bringing the state pension system back to equilibrium in the medium and long term.
- Discontinue the use of the pension system to fund unemployment and poverty-related benefits by developing a separate system to support the unemployed and poor.

2.5655 These measures are wide ranging and influence a number of key areas in the economy (enterprises, the banking system, the pension system). It is also likely that they will impose costs that need to be taken into account in the Government's overall program of expenditures as well as changes with respect to the composition of expenditures. Ultimately, for the Government to be effective it must manage these fiscal risks while at the same time reducing expenditures and making the most effective use of the resources it has at its disposal. Chapter III and IV provide more detail on how to pursue these objectives.