



A WORLD BANK COUNTRY STUDY

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# Belarus

*Prices, Markets, and Enterprise Reform*

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*Washington, D.C.*

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The analysis in this report draws on a series of special studies that were prepared by Belarusian teams of experts headed by L.A. Khankevich (Taxation), V.V. Pinigin (Enterprise Debts), B. Shapiro (Agriculture), L. Zlotnikov (Trade), and G. Turban (Exports). Sergei Shatalov (IECIF) prepared a note on the external debt of Belarus. A list of the background documents used in preparing this report is in the References section at the end of the report. The report draws significantly on the macroeconomic analysis and data prepared by the IMF during a parallel mission, but the Bank is solely responsible for

the analysis and recommendations presented here.

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## ABSTRACT

Belarus is in a major economic crisis. The trade deficit has become unsustainable. External reserves have fallen to negligible levels. The number of loss-making enterprises is increasing rapidly. Budget revenues are falling far short of targets, and the Government has announced its intention to pursue expansionary monetary and credit policies to support the loss-making enterprises in industry and agriculture, to pay workers, and to cover its own expenses.

Like all former Soviet republics, Belarus suffered the twin shocks of higher energy prices and the loss of traditional markets when the Soviet Union collapsed. The Belarusian response to these shocks, however, has been very cautious. This has seriously delayed the structural changes that are needed to increase efficiency and develop new export markets. At the same time, the Government sought to cushion the shock of the adjustment process through expansionary credit policies and lax financial discipline on enterprises. Further delays will make the transition increasingly difficult.

The adverse effects of high inflation on the investment climate were compounded by unpredictable tax enforcement and extensive government controls on pricing, business establishment, credit, and access to suitable business premises. The business environment was further degraded by slow privatization and continued widespread presence of large state enterprises with preferential access to credit, subsidies, and government purchase orders. Faced with this, private investors, both domestic and foreign,

have stayed away, and the falling levels of real net investments in fixed capital formation have created further barriers to renewed economic growth.

The situation has become notably worse in the last 18 months because the Government, instead of focusing on monetary discipline and structural reforms, began to intervene actively in the foreign exchange market to maintain an artificially stable exchange rate. The three-fold real appreciation of the Belarusian rubel against the US dollar since the end of 1994 has been the major factor causing the unsustainable trade deficit. It has also led directly to the rising rate of financial failure among Belarusian enterprises.

Escaping the current crisis and restoring growth will require rapid creation of a stable, predictable business environment that will attract the domestic and foreign investment needed to improve productive efficiency and international competitiveness. Establishing a good investment climate will require the immediate implementation of policies that will assure the competitive market determination of prices (especially for foreign exchange), strict financial discipline enforced by the effective and immediate threat of bankruptcy, a competitive market structure dominated by independent, privately owned enterprises, a transparent and predictable legal framework (especially for taxes), even-handed administration of laws, access to critical infrastructure services, and an efficient, well-targeted social safety net to protect those who need help during the transition period.

# BELARUS - SELECTED INDICATORS TABLE

Indicators	Actual				
	1991	1992	1993	1994	1995
<b>Part A: Main Macro Aggregates</b>					
<b>Annual growth rates, calculated from data in constant 1993 prices</b>					
GDP (mp) per capita	-1.3%	-10.0%	-11.0%	-12.6%	-10.0%
Total consumption per capita	-6.7%	-10.7%	-4.1%	-10.8%	-16.4%
GDP at market prices	-1.2%	-9.6%	-10.7%	-12.6%	-10.1%
Total consumption	-6.6%	-10.3%	-3.7%	-10.8%	-16.5%
Private consumption	-6.0%	-7.8%	-0.6%	-14.0%	-23.3%
Government consumption	-7.7%	-15.3%	-10.5%	-3.0%	-1.8%
Gross domestic investment (GDI)	15.3%	-15.7%	-11.6%	-33.5%	-26.1%
Gross dom. fixed investment (GDFI)	4.4%	-18.1%	-15.4%	-17.2%	-27.0%
Exports (GNFS)	-1.1%	-34.0%	-38.0%	-17.0%	-6.0%
of which Goods	..	..	..	7.3%	13.1%
Imports (GNFS)	0.2%	-43.0%	-31.9%	-39.0%	11.0%
of which Goods	..	..	..	-19.2%	14.4%
<b>Cumulative Developments (1990=100)</b>					
GDP (market price)	98.8%	89.3%	79.8%	69.7%	62.7%
Investment	115.3%	97.2%	86.0%	57.2%	42.3%
Consumption	93.4%	83.8%	80.7%	72.0%	60.1%
Exports	99.0%	65.3%	39.2%	38.7%	38.2%
Imports	100.5%	57.1%	38.1%	31.7%	30.2%
<b>Savings-investment balances, calculated as shares of GDP in current prices</b>					
Gross Domestic investment, of which	29.5%	32.3%	38.4%	28.9%	25.2%
Fixed capital formation	22.4%	25.7%	31.2%	29.2%	25.1%
Government investment	..	..	..	..	7.3%
Foreign savings (negative of cur.act.balance)	..	-4.5%	30.6%	12.5%	2.5%
Gross national savings	..	36.8%	7.8%	16.4%	22.7%
Government savings	..	0.0%	-0.6%	-0.2%	-0.3%
Non government savings	..	36.8%	8.4%	16.6%	22.9%
Gross domestic savings	32.9%	33.7%	21.4%	15.6%	20.4%
<b>Other</b>					
GDP inflation	107%	1,078%	1,097%	1,967%	647%
Annual average exchange rate (LCU/US\$) 1/	..	23	269	3,694	11,534
Index real average exchange rate (1993 =100)	..	..	100	192	257
Terms of trade index (1993=100)	..	..	100	74	87
Incremental capital-output ratio (GDI based)	-22.4	-3.3	-2.8	-2.3	-2.2
Import elasticity with respect to GDP	..	..	..	-0.58	-1.30
Money growth (% p.a.)	..	376%	956%	1931%	158%
Real credit growth in the monetary sector (% p.a.)	-3%	-7%	-73%	-33%	-20%

## BELARUS - SELECTED INDICATORS TABLE

Indicators	Actual				
	1991	1992	1993	1994	1995

### Part B: Government Finance Indicators

#### Shares of GDP (%)

Total revenues, of which	..	46%	55%	48%	43%
Tax revenues	..	40%	45%	42%	35%
Total expenditures, of which	..	46%	53%	51%	45%
Consumption	..	37%	38%	41%	39%
Deficit(-)/Surplus(+)	..	0.0%	-1.8%	-2.6%	-1.9%
Financing:	..	0.0%	1.8%	2.6%	1.9%
Foreign	..	..	0.9%	-0.9%	-0.5%
Monetary sector	..	..	0.8%	3.2%	2.1%
Other domestic	..	..	0.1%	0.3%	0.3%

#### Other

Total Debt/GDPmp	..	..	9.9%	57.6%	36.9%
Total interest payments/Tax revenues	..	..	18.0%	1.0%	2.3%

### Part C: Debt & Liquidity Indicators

#### Total DOD and TDS

DOD (US\$ millions)	0.0	189	969	1,273	1,648
DOD / GDPmp ratio	..	5%	27%	27%	16%
TDS (US\$ millions)	0.0	0.6	14.7	118.6	180.0
TDS / exports (XGS) ratio	..	0.0%	0.5%	4.1%	3.6%
Total gross reserves (months' imports G&S)	..	..	0.3	0.3	0.8

### Part D: External Financing Plan

#### US\$, millions

Official capital grants	0.0	0.0	0.0	0.0	0.0
Private investment (net)	..	7.0	18.0	10.0	7.0
Net Long term borrowing excl IMF	..	181	320	193	78
Adjustments to scheduled debt service	0.0	0	7	143	0
All other capital flows	..	-365	974	390	161
Financing Requirements (incl IMF)	..	-177	1,319	736	246
of which current account deficit	..	-182	1,113	599	254

Note: 1/ Weighted average exchange rate.

## LIST OF ABBREVIATIONS

CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
FDI	foreign direct investment
FSU	former Soviet Union
GDP	gross domestic product
IBCE	Inter-Bank Currency Exchange
IBRD	International Bank for Reconstruction and Development (The World Bank)
IMF	International Monetary Fund
MOE	Ministry of Economy
MOF	Ministry of Finance
NBB	National Bank of Belarus
RUR	Russian ruble
SOE	state-owned enterprise
VAT	value added tax
YOY	year on year

## CURRENCY EQUIVALENTS

*Belarusian Rubels (BYR) per one U.S. Dollar (USD)*

Prevailing average rate in 1995	11,500
Top of Currency Corridor	
First half of 1996	13,100
Second half of 1996	15,500
April 2, 1997	24,650
Prevailing Free Market Rate	
1995	11,000 - 12,000
June, 1996	15,000
September, 1996	18,500

## UNITS OF MEASURE

bls	=	billions
ha	=	hectares
km	=	kilometers
mls	=	millions
ths	=	thousands
trs	=	trillions

## CONVENTIONS

“East,” in the context of trade discussions refers to the former Soviet Union (mainly Russia), and “West” refers to all non-CIS countries.

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## Executive Summary

Belarus faces a serious economic crisis. Although the Government has managed to reduce the rate of inflation significantly and output is expanding in a few areas of the economy, the overall picture is unsatisfactory. Aggregate industrial output continues to fall. The number of loss-making enterprises is increasing sharply month by month. Enterprise non-payments are creating serious problems. The trade deficit has become unsustainable. Foreign exchange reserves have fallen to excessively low levels. The budget is seriously short of resources. The lack of adequate structural adjustments in the enterprise sector is creating pressures on the budget and the banking system that could easily rekindle high rates of inflation. And living standards continue to fall. But these problems can be overcome. The necessary policy changes do not require extensive research, nor are major capital investments required. The changes could be launched almost literally at the stroke of a pen.

Though simple in concept and easy to initiate, these policy changes will lead to other changes that will have a profound impact on the future prospects for Belarus. These policy measures will create an environment that stimulates investors—both foreign and domestic—to increase production in Belarus and to make it more efficient. New jobs, larger export volumes, a more stable balance of payments situation, and lower domestic inflation will soon follow. Despite these benefits, the reforms will be difficult to sustain because, in the short term, they will require adjustments such as closing or radically restructuring some failing enterprises with no future prospects for efficient, competitive production in their current lines of business.

The people of Belarus need to understand why a continuation of past policies would be ruinous, and therefore why the reforms must be completed despite the short run difficulties. They must understand what needs to be done to prevent Belarus from sliding deeper and deeper into a severe economic crisis. They must understand that distorted prices cannot be the basis for

protecting people against poverty. They must understand the importance of allowing prices to be determined by the normal interaction of supply and demand. They need to understand that everyone—individuals as well as enterprises—must pay for what they consume. If this consensus of understanding and support can be developed, Belarus can quickly lay the foundation for restoring living standards.

### Background

When Belarus became independent in 1991, it was the richest of the twelve republics of the Commonwealth of Independent States (CIS) in terms of per capita income—a status reflecting the republic's steady growth during the 1970s and early 1980s. It had developed an industrial sector that, in terms of share of total GDP, made it one of the most heavily industrialized countries in the world. The agriculture sector was modernized and came to depend not only on heavy equipment, much of which was manufactured in Belarus, but also on imported fuel and fertilizers. Industrial and agricultural development was based on oil and gas from Russia that was priced at less than 10 percent of world prices in 1990. Enterprises in Belarus also enjoyed access to material inputs for processing and final assembly at internal transfer prices, as well as heavy infusions of capital investment, and preferential access to the markets of the former Soviet Union (FSU) and Eastern Europe due to artificially low transport costs and no customs barriers. As a result, Belarus became one of the most trade-reliant nations in the world, with imports and exports each constituting 50 to 60 percent of GDP. It was also one of the FSU republics most deeply dependent on intra-regional trade, which was equivalent to 70 percent of total trade.

Belarus lost its privileged position with the breakup of the former Soviet Union. Traditional markets collapsed, and the cost of critical inputs (especially energy) increased sharply in real terms. The terms of trade loss in 1991-92 has been estimated at 11 percent of GDP. The resulting decline in production and increase

in inflation were primary factors contributing to the current economic crisis. Other countries experienced similar problems in 1990-91, but have found it easier to control inflation, stabilize their economies, and begin to restructure enterprises.

In Belarus, the problems caused by the collapse of the Soviet system were compounded by economic policies that sought to cushion and delay the transition to a market economy. Rather than implementing policies that would encourage people to adjust their living standards to the new realities and encourage enterprises to restructure and become internationally efficient, the Government sought to maintain living standards and employment through expansionary monetary and credit policies. As a result, aggregate demand far exceeded domestic production, leading to serious macroeconomic imbalances. These problems were made even worse by the distortions that were introduced to compensate for these imbalances and sustain living standards. For example, the directed credits that were used to support failing enterprises led to high rates of inflation; efforts since early 1995 to control inflation by stabilizing the exchange rate have produced a serious overvaluation of the exchange rate. This has seriously eroded the competitiveness and profitability of the enterprise sector in this traditionally open and heavily trade-dependent country.

These policies were part of an attempt to find a third way, a system that would combine the best of planned and market economic systems. The attempt has failed. The output decline is now as severe in Belarus as for the average economy of the FSU. And while other economies are starting to recover, the economy of Belarus is only beginning to stabilize and is at risk of further declines in the future. By postponing the necessary structural adjustments, Belarus has failed to establish the foundations of enterprise productivity needed for restored growth. The lack of structural adjustments in the enterprise sector now threatens even the modest price stability that has taken Belarus so long to achieve.

The failure of past policies to restore growth on a sustainable basis has hurt the people

of Belarus. According to World Bank data the average poverty rate has risen from about 5 percent to about 25 percent. Only about five percentage points of this increase in poverty has been the result of higher income inequality. The rest has been the direct result of economic decline. This report discusses ways in which the Government can protect the very poor during the transition process, but most of the emphasis is on restoring satisfactory rates of economic growth, for this is the only way that Belarus will be able to afford to take the majority of today's poor above the poverty line.

Although the Belarusian people lived well under the Soviet system, a return to the past is not feasible because, as history has shown, the Soviet system of command and control has too many built-in inefficiencies. The Soviet system worked for many years because of the vast natural resources and limited population density of the FSU, but eventually the degradation of the region's environmental and physical capital, the low efficiency of enterprises, and the growing inability to meet the needs of consumers led to the system's collapse.<sup>1</sup>

The potential for restoring growth in Belarus is excellent. The nation has a highly educated population, a disciplined work force, close proximity not only to traditional Russian markets, but to the rich European markets as well, and a history of heavy reliance on external trade. In the late 1980s, it exported a higher percentage of its output to other FSU republics than any of the other republics. By Soviet standards, its manufactured products were highly sophisticated. Nostalgia about the Soviet regime, under which Belarusians lived well, has led many Belarusian citizens and leaders to seek an alternative to market reforms including continued state ownership of production facilities. But as this report demonstrates, a return to the past is impossible. Instead Belarus needs to implement the policy measures presented in this report; a measure will allow Belarus to move out of the current stagnation and decline associated with the collapse of the Soviet-era command economy and improve living standards for all.

Belarus now needs to press forward to transform its economy into an efficient, market-based economy. This will require (a) major improvements in the policy framework to provide incentives for efficient production; and (b) substantial investments to improve the energy efficiency, product quality and competitiveness of the existing industrial and agricultural infrastructure. This infrastructure was poorly suited for competition in world markets when the former Soviet Union collapsed in 1991, and it is in even worse condition today because of inadequate investment—even for maintenance in many cases—during the intervening years. The investment required vastly exceeds that which the Government could possibly mobilize. One of the top priorities of the Government today is therefore to attract private investors, both foreign and domestic. Current rates of net fixed capital formation are close to zero, and foreign direct investment is among the lowest in the FSU and Eastern Europe on a per capita basis, reflecting serious problems with the business and investment climate in Belarus today. One of the key objectives of this report is to identify these problems more clearly and to find feasible solutions that will allow Belarus to attract the investment required to restore growth, generate productive jobs, and improve the productivity of investment, thereby allowing the country to improve living standards.<sup>2</sup>

Among the most important tasks identified in this report for improving the investment climate are (a) establishing the legal and administrative structures needed to create a market-friendly environment; (b) establishing the ownership structures and hard budget constraints required to assure that producers seek to maximize profits, thereby optimizing the use of resources; and (c) protecting people from poverty, especially those who lose their jobs temporarily because of the industrial restructuring required for the transition to a market economy.

### **Establishing Market-Determined Prices**

Until recently Belarus had made considerable progress in moving from administratively determined prices to prices determined by the interaction of competitive

market forces. Price controls on manufactured goods were removed in 1992-93, and most of the remaining price controls on food and other “items of popular consumption” were officially removed in November 1994. However, the national Government still publishes “indicative” prices for various agricultural goods that tend to be treated at the local level as the allowable market prices. More importantly, local governments impose profit margin controls on certain socially sensitive goods such as dark bread and milk. Because the cost accounting systems of Belarusian enterprises do not make adequate allowance for the impact of inflation and, in some cases, do not allow certain production and marketing expenses to be counted as costs, profits are often seriously overstated, and controls on profit margins therefore result in a severe erosion of working capital. Such controls should be eliminated at all levels as soon as possible to help assure the financial viability of enterprises, and the efficient use of their goods and services. Concerns that monopolistic market structures will distort prices are legitimate. In such cases, the Government should use regulated prices as a last resort, working instead wherever possible to create competitive markets through demonopolization, privatization, and removal of barriers to trade and private sector development. This would also help reduce the *de facto* price distortions caused, for example, by government-owned trading enterprises that hold prices to artificially low levels for “social” reasons.

The Government has significantly reduced the number of “monopolistic” goods that are subject to price controls, and has sharply increased prices for many goods and services such as electricity and heating that are still subject to state control. But much remains to be done. For electricity and heating, the two largest elements in housing costs, charges still cover only about 70 percent of costs, and charges for gas and hot water, the next two most important items, cover only about 55 percent of costs. Furthermore, cross-subsidization is still a major problem, with commercial users being forced to pay energy prices well above costs—one of the factors contributing to the large number of loss-making enterprises in this sector. Price reforms are difficult but vitally important to efficient resource

allocation, and thus to prospects for growth and improved living standards, as are efforts to increase the efficiency of energy production and consumption. Raising prices to allow efficient cost recovery will reduce poverty in the medium term by promoting efficiency and economic growth, and by increasing the resources available to the Government for targeted poverty reduction programs. While care must be taken to control fiscal costs, the adverse short-term social impacts of full cost recovery can be reduced with appropriate social safety net programs.

The most seriously distorted price today in Belarus is the price of foreign exchange. This happened because the Government attempted to control inflation by controlling the exchange rate. The focus of anti-inflation policies should instead be on controlling monetary emission, imposing strict financial discipline, maintaining tight fiscal restraint, and creating an environment that encourages investment and growth. The overvalued domestic currency has, during the past 18 months, been an increasingly important cause of continued decline in industrial output, the growing number of loss-making enterprises, the unsustainable trade deficit, the rising energy arrears with Russia, the continued reliance on administrative controls, and the loss of jobs. Establishing an exchange rate that restores the competitiveness of Belarusian enterprises is of highest priority.

An open external trade policy is also critically important in avoiding monopolistic pricing within the domestic market. As one of the most heavily industrialized and trade-dependent economies in the former Soviet Union, Belarus has factories designed to serve the entire FSU market as well as major markets in Central and Eastern Europe (CEE). Belarus has sold some products to international markets as well. These enterprises clearly have a monopolistic position within Belarus, and unless external trade policies assure that they are subject to potential competition from imported goods, these enterprises will almost certainly charge excessive, monopolistic prices to Belarusian consumers. Breaking up all of these large factories into competing units is not feasible because of the loss of economies of scale in production. Maintaining

open borders and the threat of competition from imports, on the other hand, would also provide local enterprises with incentives to improve design quality and production efficiency, making Belarusian products internationally competitive and providing more jobs to Belarusian workers. The improved performance would also assure lower prices and higher quality for goods sold to domestic consumers—for both final goods and intermediate inputs. The latter point is important, because if Belarusian factories are forced to buy high cost, low quality inputs from local sources, their products will become non-competitive in world markets, thus reducing the prospects for growth, employment, and improved living standards.

### **Establishing Profit-Oriented Producers**

A market economy will not allocate resources efficiently unless producers generally seek to maximize profits. Otherwise, resources will be used inefficiently, slowing down economic growth and poverty reduction. Under the Soviet system, profit maximization was not explicitly an objective in most situations. If an enterprise was in a priority sector, the state would arrange for the banking system to transfer the necessary resources through directed credits to keep the enterprise in operation. The failure to set profit maximization as a primary objective is one of the most important factors in the collapse of the previous system. Overcoming this heritage is extremely difficult. Allowing prices to be set in competitive markets as noted in the previous section is of course a precondition; otherwise, profit maximization will become monopolistic exploitation. Well-functioning markets are necessary but not sufficient, however. If Belarus is to create an environment that attracts the level of foreign and domestic investment needed to attain the desired levels of growth, and if that investment is to be efficient, it will also need to make some fundamental structural changes to encourage the same kind of profit-maximizing behavior that is typical in the commercial environment of a normal market economy. Most importantly, it will need to: (a) impose hard budget constraints, using bankruptcy as an incentive for financial responsibility where necessary; (b) privatize a major share of state-

owned enterprises to avoid the conflicting objectives that frequently prevent public enterprise managers from maximizing profits and thus using resources efficiently; and (c) encourage the establishment of new competing firms.

**Hard Budget Constraints and Bankruptcy.** One of the most urgent tasks for the Government of Belarus at this point is to impose and enforce hard budget constraints on all economic agents in the country—enterprises, individuals, and equally important, on the Government itself. A market-based system of allocating resources cannot work—and market-determined prices will be irrelevant—if enterprises and others do not pay their bills. The Government does not have to act as the nation's bill collector. However, it should establish a framework of laws and a system of tight fiscal and monetary discipline so that creditors, especially the banking system, will be able to take effective action against those who fail to pay their bills on time.

Non-payment has reached serious levels in Belarus. The lack of payments discipline creates a chain of debts that leads to widespread financial problems in the economy. Good enterprises in Belarus are being destroyed by other enterprises that do not pay for their purchases. This discourages serious investors from trying to do business in Belarus. Banks are facing liquidity and even solvency problems because of the overdues on loans, thus making capital excessively costly to investors, if it is available at all. Workers and their families are suffering because enterprises do not pay wages on time. And the Government is facing a severe shortage of revenues because enterprises are not paying their taxes. This in turn creates pressures on the Central Bank to make loans to the Government, creating inflationary pressures as the money supply expands. The excess of government expenditures over revenues also diverts resources that could otherwise be invested by the business community in economic recovery.

Rather than improving the situation, the Government is actually making it worse in at least three ways. First, it is subsidizing loss-making

enterprises by allowing them to delay and reduce the amounts of tax owed. Second, it allows agricultural enterprises that supply food for government procurement to delay payments to input suppliers without penalty. Third, the Government itself is not paying its bills on time; because of policies such as the sequestration of funds, the Government's "expenditure arrears" or overdue bills have risen sharply in recent months.

Experience throughout the world indicates that the most effective means of imposing hard budget constraints is the credible threat of bankruptcy. Even if very few enterprises are taken into bankruptcy, the threat of losing ownership of one's assets, and control of one's enterprise is usually enough to assure that managers will do everything possible to pay their bills. Faced with the threat of bankruptcy, managers will spontaneously reform their enterprises to improve efficiency or they will go out of business, freeing resources for those who can manage them more efficiently. For example, they may lease or sell unused buildings and equipment, dismiss idle workers, seek new markets, develop new products, invest in new technologies, and seek new partners, both foreign and domestic, who can inject new capital and management expertise—all key ingredients of any successful strategy for enterprise reform. Without the threat of bankruptcy, however, such reforms, including privatization, will probably have to be imposed through administrative decree by the Government, and this is generally a very inefficient way to obtain economic efficiency. Therefore, an effective bankruptcy law, backed up with a judicial system that makes bankruptcy a credible threat, is essential for meaningful enterprise reform, an improved investment climate, and restored economic growth.

**Privatization.** Privatization should be seen not as an objective per se, but as one of the best possible ways to assure that enterprise managers try to maximize profits, thereby increasing economic efficiency and growth. Public enterprise managers could in theory attain the same levels of efficiency that managers of private manufacturing enterprises do.<sup>3</sup> However, several factors make such occurrences quite rare. First, because public enterprises are owned by

government, they are far more subject to political pressures than are private enterprises. This is seen today in Belarus—the Government asks (often unofficially and indirectly) that enterprises retain excess employees and provide goods and services below cost for social reasons. This drain on their earnings reduces the incentives for public enterprise managers to maximize efficiency, increases incentives to seek subsidies from the Government, and distorts the prices of goods and services in the economy. Second, the benefits from efficient production in the form of extra profits generally go to the Government rather than to the public enterprise itself. Furthermore, profitable public enterprises commonly find themselves subject to pressures to take on various social responsibilities or to increase their payments of dividends to the Government so that these resources can be used to help ailing enterprises. In private enterprises, owners and managers have their own funds at risk, and what happens to these funds depends on their making good decisions. This, combined with the real threat of bankruptcy, is a powerful force for efficiency. Privatization also helps the Government, because once enterprises are privatized, it is much more difficult for them to pressure the Government into extending subsidies, concessional credits, tax relief, and other financial privileges.

Privatization in Belarus has gone very slowly, and this helps explain why it has been so hard to reverse the continuing economic decline. The 1995 privatization program was never approved by the President for implementation, and while the 1996 program has been approved, very limited progress was made during the first six months of the year. As a result, only about 6 percent of the republican enterprises and about 10 percent of the smaller communal enterprises have been privatized. Almost no enterprises have been “corporatized” (transformed into joint stock companies) during the past year. A large share of the enterprises that have been corporatized remain owned by the Government, leaving them subject to the various non-economic pressures and inefficiencies noted above. The voucher distribution phase of the privatization program was completed by mid-1996, but delays in

preparing enterprises for privatization have created a serious shortage of enterprises that can be sold for vouchers.

In sum, to establish the preconditions needed for higher efficiency, increased investment, restored economic growth and improved living standards, the Government needs to move as quickly as possible to complete the liberalization of prices, impose hard budget constraints, and stimulate privatization.

### **Protecting the People**

If implemented in a timely manner, the measures outlined here will make a major contribution to reducing poverty in Belarus by reversing the economic decline of the past five years. The transition to a market economy inevitably creates social problems, however. The most difficult problem from a social perspective is the short-term loss of jobs as workers move from failing enterprises to healthy ones. Good government policies can prevent or reduce these problems. In particular, the Government needs to create the best possible environment for the development of small-scale enterprises, for they offer the best prospects for expanding the availability of new jobs. Policies such as the abolition of the “propiska” (a residency/work permit system), the decontrol of wages, and improved access to rental housing in growth areas should also be implemented to improve the flexibility of the labor market. Finally, recognizing that some people will become poor for more than a short time during the transition process, the current system of social protection needs to be improved to assure that it can provide, in a fiscally sustainable manner, a cost-effective combination of means-tested social assistance, categorical assistance to certain groups (especially single-parent families with a large number of children), unemployment insurance, and insurance-based programs for health and old age.

The Government needs to make a radical change in its approach to providing a social safety net for the poor. In the past, the Government has sought to help the poor—and many other groups in society—by distorting prices. Food, housing, energy, and transport were all made available at

artificially low prices that did not cover the costs of production. The Government has made it very difficult for enterprises to get rid of excess labor, thus distorting the normal functioning of the labor market. To compensate farming, manufacturing, and public transport enterprises for their losses due to the artificially low prices that they were able to charge consumers and the excess workers that they were forced to retain, the Government has distorted the prices and allocation of credit, energy, raw material inputs, and foreign exchange. These distortions in prices to the enterprise sector led to further economic problems. For example, the high levels of payments arrears to Russia for gas developed because the gas distribution companies did not receive enough money from the enterprises to buy the foreign exchange needed to pay Russia. This restricted the demand for foreign exchange, contributing to the overvaluation of the domestic currency and thereby inflicting further losses on exporters in the industrial and agricultural sectors. In short, although intended to help the people of Belarus, in many cases the Government's past policies created or prolonged serious economic problems. The damage can be repaired. But doing so will require a fundamental shift in the way the Government goes about protecting the poor.

The Government's draft economic plan, *The Major Trends of Social and Economic Development of the Republic of Belarus for 1996-2000*, stresses that Belarus wants to create a socially-oriented market economy. To the extent that this implies a concern for basic human rights and individual dignity, this is the objective of virtually every civilized nation in the world. People are very important. But the way in which governments help people is also very important. Belarus should be supported in its desire to create a market-based economy that creates a good living environment for people, but for this strategy to succeed, Belarus needs to use the approach normally followed in successful industrialized countries. *The Government needs to move from a social assistance strategy based largely on price distortions to one based on the taxation and redistribution of efficiently produced income.*

Past attempts to protect the poor of Belarus by distorting prices are a major source of the serious economic problems facing the country today. For example, artificially low prices for bread, milk and meat have helped to destroy the financial viability of farms and the agro-processing industries. To compensate, the Government provides excessive amounts of credit at artificially low interest rates. This creates inflation that eats away the value of the credit, resulting in shortages of real working capital and investment resources despite the credit expansion. To compensate, the Government provides subsidies, many of which go to the most inefficient enterprises because they have the most serious financial problems. To meet the fiscal burden, the Government raises tax rates to excessively high levels that discourage honest businessmen, then covers the remaining budgetary shortfall with inflationary borrowing from the Central Bank or with funds borrowed from the enterprise sector that would better be used by the enterprises for investments in more efficient equipment. Another example of the problems caused when the Government tries to help the poor by distorting prices is its efforts to hold down the price of energy, especially electricity and heating. This has been done by keeping the domestic currency overvalued and by charging consumers less than the full cost of energy. The overvalued currency destroys the competitiveness of Belarusian producers in both foreign and domestic markets, leading to enterprise failures and the loss of jobs. And the low cost recovery rates have led to financial problems for local utility companies and to unacceptably high levels of arrears in payments to Russia for imported gas and oil.

The poor need to be protected, but this should be done instead with revenues derived from modest levels of taxation on economic activity that has been maximized by allowing competitive markets to price all inputs and outputs at their true value. With undistorted prices for inputs and outputs, enterprise efficiency will increase and new investors will be attracted, thereby increasing output, tax revenues, and the ability to fund social protection programs.

The system for protecting the poor also needs to be redesigned so that it depends more heavily on means-tested social assistance programs. Given the administrative cost of means-testing, short-cut approaches will be required. For example, programs should be made "self-selective," placing the burden on those who want assistance to come forward and prove their eligibility. Claims from high risk groups such as families headed by a single parent and families with a large number of children could generally be accepted at face value with only limited random audits. Actual means testing, aside from reviewing the papers submitted to support such claims, could be limited to groups falling outside the high-risk categories, thus minimizing the administrative burden of introducing a means-tested income transfer program. Improvements are also needed in the efficiency and equity of the insurance programs for unemployment, health insurance, and old age.

### Outline of Document

After a review of recent economic developments in Chapter 1, the report identifies the measures needed to create an efficient, productive market economy that will attract the investment necessary for increasing productivity and improving living standards in Belarus. Chapter 2 examines the measures that are needed to establish the market-determined prices required to guide the efficient allocation of resources. Chapter 3 outlines the actions required to establish profit-maximizing enterprises. Recognizing that these actions will involve major short-term dislocations for many Belarusian workers as they move from non-viable to viable jobs, Chapter 4 describes the actions needed to protect people, particularly the poor, during the transition process. Chapter 5 concludes the report with a discussion of three scenarios that illustrate the future prospects of the Belarusian economy under alternative policy strategies, and of the resources that will be required to finance the transition of Belarus to a market economy.

### Key Themes and Conclusions

The analysis presented in this report leads to the following important conclusions, which are developed more fully in the following chapters:

- First, a return to the past is not feasible. The previous system, to which many people in Belarus would still like to return because of the many benefits they enjoyed, collapsed because the system was intrinsically inefficient. It tried to allocate resources based on decisions made by a relatively small group of government administrators based on a variety of economic, social and political considerations. This system, despite its high ideals, cannot compete in the real world with economic systems where resources are allocated to maximize profits, and consumer welfare is based on the individual decisions of those most directly affected.
- Second, the inefficiency by world standards of Belarusian enterprises today, particularly those in industry and agriculture, is the main source of the country's economic decline and poverty.
- Third, this inefficiency can only be overcome by creating the competitive, efficient product and factor markets and profit-maximizing production systems in Belarus that exist in Europe and elsewhere in the industrialized world.
- Fourth, substantial investments will be required to physically transform the production sector in Belarus, and this level of investment can only be attained if Belarus creates (a) an investment climate that attracts private investment from both domestic and foreign sources, and (b) a market-driven incentives framework that ensures efficient production and sales decisions.
- Fifth, these goals cannot be reached in a system where the majority of production activities are still controlled by the state. Attempting this would simply perpetuate the problems of the past. Consequently, privatization, which has moved very slowly to date, must be accelerated dramatically to assure appropriate incentives for profit-maximizing behavior of managers within a market-oriented environment such as exists in all successful industrialized countries.
- Sixth, hard budget constraints—rules that force enterprises to spend no more than they earn or can responsibly borrow—must be imposed to control inflation and to provide the incentives that will lead to spontaneous, efficiency-oriented privatization and production decisions.
- Seventh, the transition process will involve hardships for those who must leave their



present jobs and look for new ones. The social safety net needs to be focused on protecting these workers and their families while, at the same time, maintaining their incentives to find

new, more productive jobs. The social safety net should be provided through programs financed with tax revenues, not by distorting the prices of goods and services.