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Towards a New Pattern of Economic Governance

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Towards a new pattern of economic governance

Executive summary

The current system of socio-economic governance is only partially able to deal with the economic challenges Belarus faces, as different assessments in the recent past suggest. The economic policy strategy in recent years appears to have aimed to maintain the status quo. The existing economic governance structure has remained unchanged for more than two decades. Especially in an environment where global demand is weak and external conditions are difficult to navigate, it takes increasing efforts to deliver efficient outcomes in terms of growth.

Over the past two decades, the Belarusian economy benefited from close economic relations with Russia and cross-border economic cooperation. This economic situation is changing rapidly now. Economic growth is expected to enter a period of stagnation, partly due to the recent changes in the external economic environment and partly because of the long-overdue structural adjustments. The institutional efficiency of the existing economic governance structure is decreasing, which inhibits economic efficiency and will continue to diminish the country's international competitiveness and growth perspectives.

The Policy Paper does not provide explicit recommendation of reforms. The current approach of economic governance does not fit within the changed economic circumstances and hence to Belarus' needs. The aim of the paper is to show the current state of the economic governance structure in Belarus and to identify the key issues that shall be addressed to improve the effectiveness and efficiency of the economic governance structure of the country.

Economic governance is a very broad concept that includes a wide range of different formal and informal institutions: state and private institutions ordering within the law, for-profit-governance, and social networks and norms. Hence, there are few indicators (if some at all) that might be controlled for if different institutional solutions are compared (Voigt, 2013). The institutional quality is usually measured through efficiency and effectiveness of economic governance structure in pursuing economic policy goals. Since one knows that institutions matter, the overall measure is the economic development and growth.

To respond to the new challenges, the Government of Belarus shall address two key issues of economic governance: The short-term issue is the enhancement of efficiency of the current economic governance structure, including administrative bodies, state-owned enterprises and private companies. The medium-term issue concerns in-depth structural reforms to change the nature of socio-economic institutions. For a transition process design, Belarus might use approaches developed in other former centrally planned economies that underwent institutional transition. The experience of the new EU member states differs from the experience of China. Both approaches (fast versus gradual transition) have demonstrated that appropriate institutional changes provide a basis for higher and more sustainable growth in the long term. However, in the light of these different experiences, the institutions and structural changes should be chosen and adopted carefully, taking into account particular "initial" conditions.

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1 Introduction

Belarus faces the challenge of regaining its economic strength under increasingly difficult circumstances. Economic growth is expected to enter a period of stagnation. Despite the modernisation process – aimed at increasing total productivity and quality of production - there are increasing shortcomings on demand and supply sides. The internal market is a small size. The country's most important external market, Russia, is facing economic difficulties. And crude oil is continuing its downtrend. Belarus has strongly benefited from the refining and re-exporting of Russian oil and gas.

Similar challenges face other emerging market economies. Recently conducted assessments of emerging markets, like the IMF (2014b), explain the slowdown in growth by structural bottlenecks, highlighting the important role of structural reforms "in raising potential GDP and securing solid growth performance going forward" (DB research 2015, p. 3). According to the IMF, study structural reforms are urgently required to raise potential GDP, improve productivity and secure sustained growth in the long term. The acknowledgment of the necessity to eliminate bottlenecks to growth and the ability of governments to deliver appropriate structural reforms are key issues that will differentiate emerging markets' economies performance over the next several years.

The current approach of economic governance in Belarus is only partially able to face new challenges. The existing economic governance structure has remained unchanged for decades. Especially in an environment where global demand is weak and external conditions are difficult to navigate, it takes increasing efforts to deliver efficient outcomes in terms of growth. The existing set of economic governance institutions does not fit the changing economic environment and, hence, Belarus' needs.

To respond to these challenges, the Government of Belarus shall address two key issues of economic governance: The short-term issue is the enhancement of efficiency of the recent economic governance structure, including administrative bodies, state-owned enterprises and private companies. The medium-term issue concerns in-depth structural reforms to change the nature of socio-economic institutions. The experience of other transition countries has demonstrated that appropriate institutional changes provide a basis for higher and more sustainable growth in the long term. However, in the light of this experience, the institutions and structural changes should be chosen and adopted carefully, taking into account particular "initial" conditions.

The aim of the paper is to show the current state of the economic governance structure in Belarus and to identify the key issues that shall be addressed to improve the economic performance of the country. A special focus is put on the experience of other former planned market economies regarding institutional transition.

This policy paper is structured as follows: The next chapter provides a short overview of the definition and measures of corporate governance. The third chapter describes the recent economic governance structure in Belarus. This is followed by a chapter which shows that a rapidly changing economic environment requires action in terms of structural adjustments and institutional transition. The fifth chapter presents recent empirical studies on the transition process in the new EU member states and in China. The last chapter concludes the paper.

2 Economic governance: a short overview

Few issues in economics have experienced such a grandiose revival as the role of institutions in economic development. The institutional tradition goes back to the writings of Thorstein Veblen in the United States at the end of the nineteenth century and to the German Historical School represented by authors such as Schmoller. The role of institutions was also recognised in the early writings of development economists (Hirschman, 1970). However, North (1990) finally formulated the role of transaction costs, imperfect information and path dependence that was fully integrated into the analytical framework of mainstream economics. Since North's contributions, institutional change has become an indispensable part of economic analysis.

One of the most promising terrains for an application of institutional economics has been provided by the transition process in China and in Central and Eastern Europe. Since the '70s, China, and, since the beginning of the 90s, Central and Eastern European countries have undergone an institutional change. The reconstruction and modernisation of post-communistic economies towards sustainable market economies meant a systemic change. The main focus was put on those areas that were considered to fall under the heading of creating market systems, e.g., on price liberalisation, on privatisation and on legal frameworks for business. The general assumption is that development and growth would follow once the objective of installing an appropriate institutional framework for a market economy has been achieved. Economic governance has gained in importance.

2.1 Definition

In order to consider the issue of economic governance, one needs to clarify the term. Williamson (2005) describes economic governance rather statically as good order and workable arrangements. Dixit (2008, p. 3) has a more dynamic view on economic governance: 'Economic governance consists of the processes that support economic activity and economic transactions by protecting property rights, enforcing contracts, and taking collective action to provide appropriate physical and organisational infrastructure. These processes are carried out within institutions, formal and informal. The field of economic governance studies and compares

- the performance of different institutions under different conditions,
- the evolution of these institutions,
- and the transitions from one set of institutions to another.

In the light of the experience of institutional change, one knows that different economies at different times have used different institutions to perform these functions. They did it with different degrees of success. Hence, the field of economic governance is continuously growing. Numerous works study and compare these different institutions using theoretical models and empirical and case studies. They all are aimed at analysing 'the performance of different institutions under different circumstances, of how they relate to each other, of how they evolve over time, and of whether and how transitions from one to another occur as the nature and scope of economic activity and its institutional requirements change' (Dixit, 2008, p. 4).

2.2 Measures

Economic governance is a very broad concept that includes a wide range of different formal and informal institutions: state and private institutions ordering within the law, for-profit governance, and social networks and norms. Hence, there are few indicators (if some at all) that might be controlled for if different institutional solutions are compared (Voigt, 2013). The institutional quality is usually measured through the efficiency and effectiveness of economic governance structure in pursuing its goals. Since one knows that institutions matter, the overall measure is the economic development and growth.

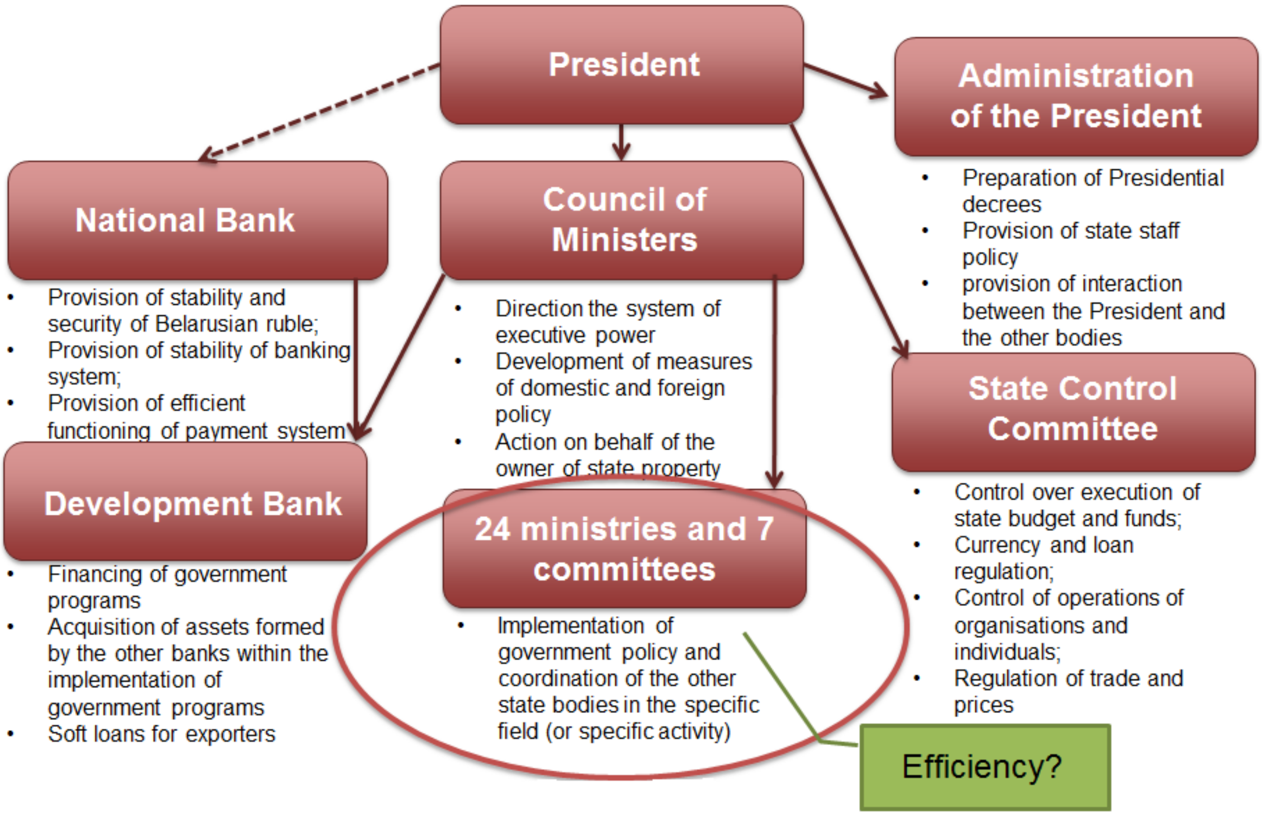
3 Structure of economic governance in Belarus

During the last two decades, Belarus has experienced a period of high economic growth and rising welfare. Between 1995 and 2011, real GDP almost tripled. Hence, the economic governance structure has undergone very few changes. The President has a very important role in the Belarusian economic governance structure: he or she has wide powers and influences the other state bodies directly or through staff decisions. The Administration of the President is the body that prepares Presidential Decrees, provides interaction of the President and the other state bodies, and provides state staff policy. The Council of Ministers is the central body of economic governance, which directs the system of executive power, executes the measures of foreign and domestic policy, acts on behalf of the owner of state property and performs other functions assigned by the Constitution and other laws. Ministries and state committees implement government policy and coordinate the other state bodies in the specific field (or specific activity). Their responsibilities are sometimes not very clearly defined, so functions can be inefficiently doubled. The State Control Committee is subordinated to the President directly.

The National Bank is responsible for Belarusian ruble stability and security as well as provides stability for the banking system and payment system. The Development Bank, founded by the Council of Ministers and National Bank, has the main aim of financing government programs (Figure 1).

Figure 1

Economic Governance Structure in Belarus

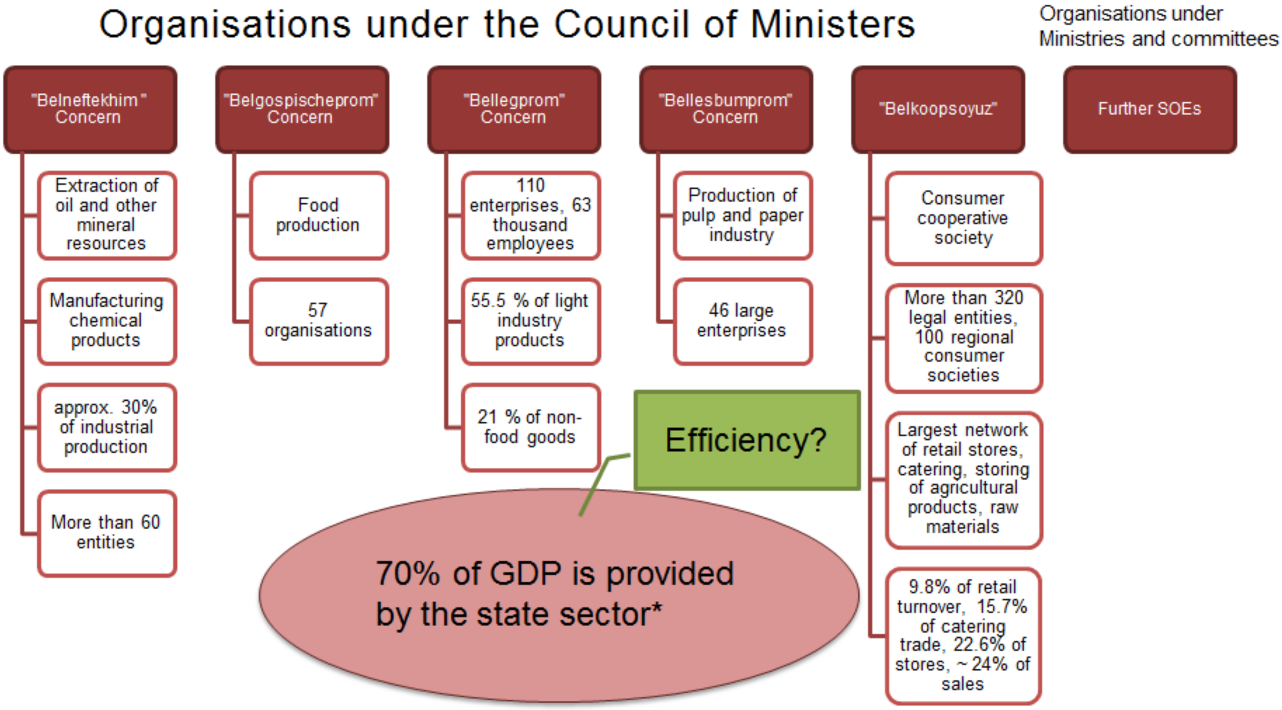


Source: own compilation

While approximately up to 70% of Belarusian GDP is provided by the state sector, efficiency of state enterprise management plays a key role in the economy. A number of large concerns – organisations that unite a lot of enterprises in a specific field – are subordinated to the Council of Ministers directly, while others are subordinated to sectoral or functional ministries and committees (Figure 2).

Figure 2

State-owned Enterprises (SOE)



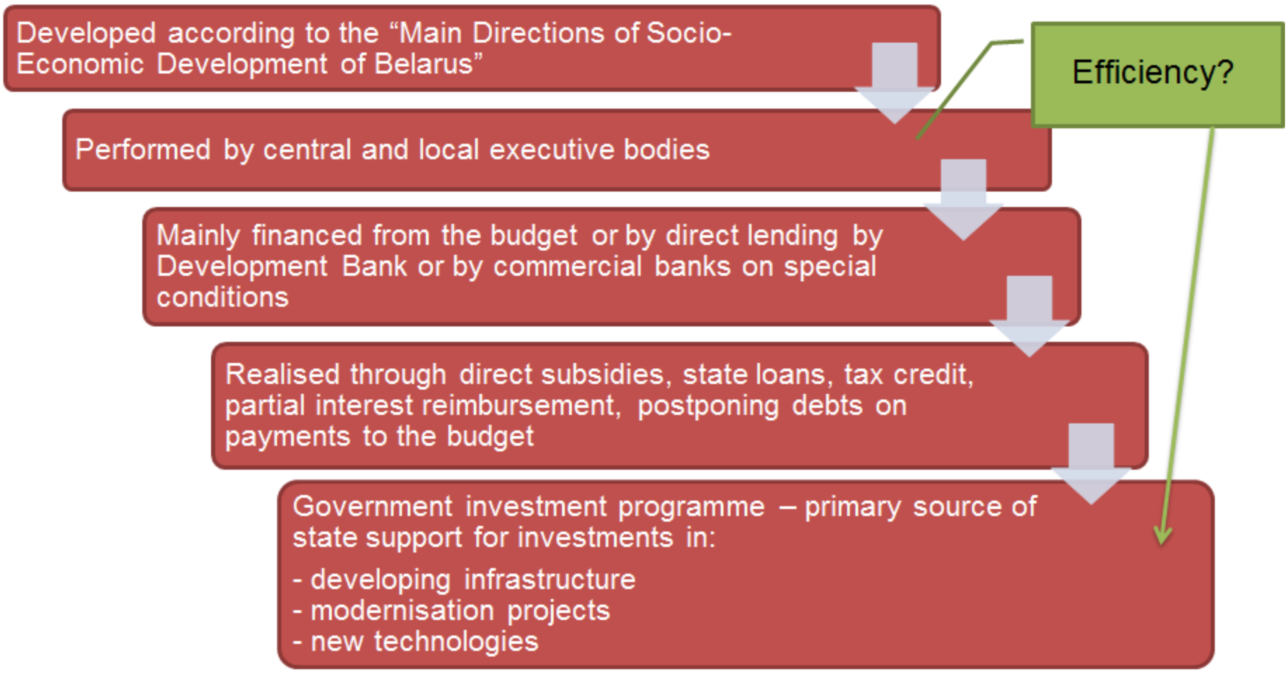
Source: own compilation
**EBRD data, dependent on indicators*

The high share of state-owned enterprises in the economic landscape imposes pressure on the Belarussian state in two ways: First, the ownership and management are often concentrated to allow for an easier control of economic activities. That might have an adverse effect on productivity and efficiency of enterprises. Secondly, the ownership of enterprises incurs considerable costs in terms of investments and wage payments on the state budget.

Further, government programmes play an important role in budget expenditures: the programmes are partially or fully financed by the state or through other state funds through a number of instruments. Government programmes are the main source of state support in infrastructure development, modernisation and new technologies (Figure 3).

Figure 3

Government Programmes



Source: own compilation

Governmental programmes are an important source of economic development. The government should concentrate on two aspects: efficiency of administrative proceeding and the efficient and effective use of investments. As long as all responsibilities are concentrated in one area, it would be difficult to produce a significant impact on economic development and growth.

4 Changes of economic environment

During the past two decades, the Belarusian economy benefited from close economic relations with Russia and cross-border economic cooperation. Strong import demand in Russia supported growing exports of Belarusian engineering products. Partly thanks to the supply chains preserved from the past, Russia has also imported capital goods and invested in the Belarusian economy. This external stimulus supported general economic growth and contributed to relatively balanced public finances (WIIW, 2014).

This economic situation is changing rapidly now (Chart 1), partly due to the recent changes in the external economic environment and partly because of the long-overdue structural adjustments. Decreasing institutional efficiency inhibits economic efficiency and will continue to diminish the country's international competitiveness and growth perspectives.

The existing set of institutions does not fit the changed economic circumstances and hence Belarus' needs.

The short-term need is to enhance the efficiency of administrative bodies, state-owned enterprises and private companies. The reform steps have to be chosen carefully and implemented in cooperation with administrative bodies.

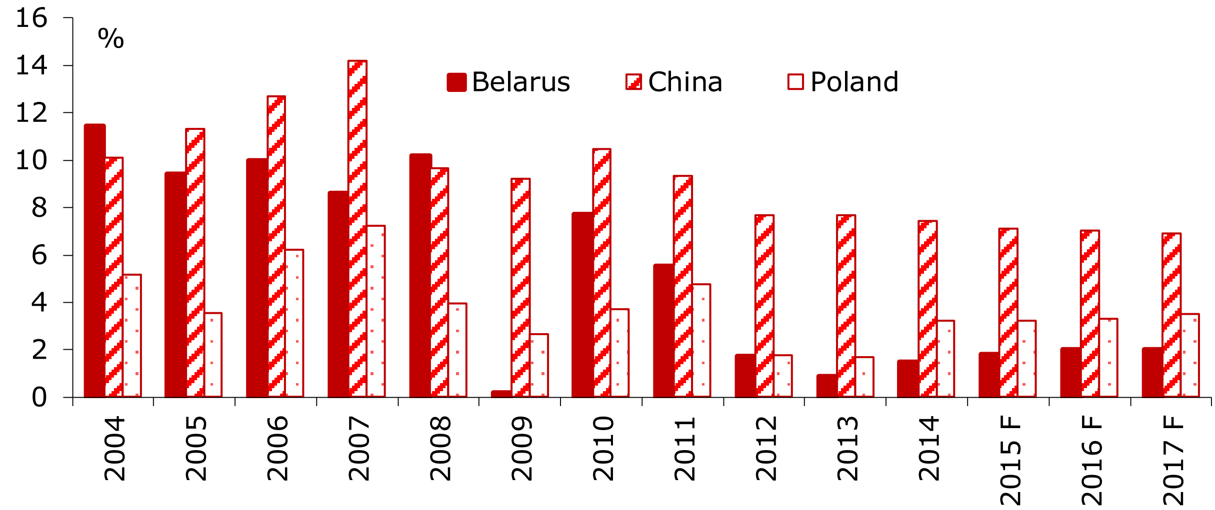
A positive impact is expected from the following steps:

- Relieving of administrative bodies through more effective and rules-based decision making;
- Deeper and broader coordination of administrative activities;
- Separation of ownership and management of SOE;
- Higher shares of outsider instead of insider ownership;

- Stronger institutions of corporate governance aimed at creating investment incentives;
- Prioritisation and evaluation of government investment programmes.

Figure 4

Annual growth in Belarus, China and Poland (in %)



Source: World Bank

In the long term, Belarus needs to undertake steps of gradual institutional transition. Due to budgetary and economic situations, structural adjustments should target the most areas prevailing state control over economic activities and introduce a broader range of market-led segments. Here, the experience of other former centrally planned economies should be taken into account and, where appropriate, used to initiate and promote structural changes.

5 Transition strategies

Economic transition is a process of determined radical institutional change, a process of building new institutions as required by a market economy. The process of institutional change towards a market economy is determined by political will; thus, the government plays an important role in carrying out economic reforms. Two different transition strategies exist and were applied in transition countries such as the new EU-member states and China. The first strategy advocated a radical change process (known as the "Big-Bang" transition strategy) involving the immediate destruction of old institutions and a rapid conversion to free market arrangements. The second – gradual – strategy focused on the implementation of key institutional principles of the market economy through a slow trial-and-error process.

5.1 Transition process in the new EU member states

The accession strategy for the EU enlargement has been built on the formal ex ante harmonisation of institutions. The institutional underpinning of market economies is a 'clearly delineated system of property rights, a regulatory apparatus curbing the worst forms of fraud, anti-competitive behaviour, and moral hazard, a moderately cohesive society exhibiting trust and social cooperation, social and political institutions that mitigate risk and manage social conflicts, the rule of law and clean government' (Rodrik 2000, p. 2). Establishing effective, appropriate, market supporting institutions has been regarded as the necessary condition for an internal common market, and it is reflected in the European Union law (acqui communautaire). The EU's institutional framework is assumed to be effective primarily because it enables an internal common market free of distortion and then it might help to foster the trend to further economic integration within the EU. To this best (praxis proven) coherent combination of effective institutions, Central and Eastern European countries have also had to converge before the EU accession to ensure macroeconomic stability and to enhance economic growth.

The European Bank of Reconstruction has developed and published 'transition indicators' to monitor the progress of individual countries in building sustainable market economies to create preconditions for the accession to the EU Common Market (similar to aqui communautaire). Since 1994, such 'transition indicators' have become one of the most-used sources to analyse economic and social developments in Central and Eastern Europe as well as in the former Soviet Union. The recent assessment of institutional transition and convergence towards EU norms, like Grusevaja/Pusch (2014), reveals the pattern of institutional change in the EU new member states.

The study uses five time spans to identify the progress of institutional adjustment.

1. Period 1991-1994 (4 years) is the period preceding EU membership application in most CEECs. It is also the time immediately following the political change after the breakdown of communist regimes.
2. Period 1995-1998 (4 years) is the period in which most CEECs applied for EU membership and association agreements were concluded.
3. Period 1999-2003 (5 years) is the period when accession negotiations were opened and concluded for most of the CEECs.
4. Period 2004-2006 (3 years) is the period when the first enlargement took place and 8 CEECs became members of the EU.
5. Period 2007-2010 (4 years) is the period when Romania and Bulgaria joined the EU. It is also a time when the financial crisis hit the CEECs.

For those five time spans, institutional data were taken from the EBRD transition indicator data base which provides expert assessments (in the form of indices) of the institutional framework in a number of areas. For accuracy reasons, transition countries which do not belong to the EU accession group of CEE countries were also included in the data base. The latter can be qualified by the similarity of institutional starting conditions in the post-communist countries and their possibility of developing different institutional settings in the transition period, including the convergence of EU norms. The EBRD database comprises 27 former communist countries from the CEE region, the Balkans, the CIS region and Mongolia.

A number of transition countries are highly dependent on commodity exports which can lead to major shifts in GDP growth as well as a lack of political pressure for institutional reforms. For this reason, we did not include oil-exporting countries of the CIS and Mongolia (which export a number of other commodities) in our database. Belarus was also not included as it has strongly benefited from the refining and re-exporting of Russian oil and gas (Balmaceda 2006). Altogether, our database comprises a selection of CEECs, the Ukraine, Moldavia, Armenia and Georgia (20 countries).

Box: Structural change on the basis EBRD transition indicators (prevailing growth model):

- Large-scale privatisation
- Small-scale privatisation
- Enterprise restructuring
- Price liberalisation
- Trade & Forex System
- Banking Reform & interest rate liberalisation
- Securities markets & non-bank financial institutions
- Competition Policy

The EBRD transition indicators are coded as numbers and should be understood in a qualitative way:

– "1" no steps or almost no steps towards EU norms
– "2" some steps towards EU norms
– "3" significant progress
– "4" substantial improvement in the considered institutional field
– "4.3" institutional standards of typical advanced industrial economies

Overall, the development of clusters suggests that a strong leap forward in institutional compliance with the EU norms - reflected in the EBRD transition indicators - has been made from 1991 to 2003 in all new EU member states. From 2004, this dynamics slowed down. The following Table 1 illustrates this development of different indicators as average per period and per cluster. Green-marked numbers show institutions with the most significant development and red-marked numbers with the weakest development.

Table 1

Institutional convergence in the new EU member states

	Large scale privati-sation	Small scale privatisa-tion	Enterprise restruc-turing	Price liberali-sation	Trade & Forex system	Banking re-form & inter-est rate liber-alisation	Securities mar-kets & non-bank financial institutions	Compe-tition Policy
2007-2010, all countries	3.5	4	2.7	4.2	4.2	3.3	2.7	2.7
Cluster 1 (EE,LV,LT,HU, PL,SK)	3.8	4.3	3.4	4.3	4.3	3.8	3.4	3.4
Cluster 2 (BG,HR,RO,SI)	3.5	4.1	2.8	4.2	4.3	3.6	2.9	2.8
Cluster 3 (AL,AM,MK,GE)	3.6	4	2.4	4.3	4.3	2.8	2	2.2
Cluster 4 (BA,MD,ME,RS,UA)	3	3.7	2.1	4	4	3	2	2.1
2004-2006, all countries	3.4	4	2.7	4.2	4.2	3.2	2.5	2.4
Cluster 1 (PL,HU,CZ,EE, LT,LV,SK)	3.8	4.3	3.4	4.3	4.3	3.8	3.3	3.2
Cluster 2 (BG,HR,RO,SI)	3.5	4	2.8	4.2	4.3	3.5	2.6	2.5
Cluster 3 (AL,AM,MK,GE,MD, UA)	3.2	3.9	2.2	4.2	4.2	2.7	2	2.1
Cluster 4 (BA,RS)	2.6	3.2	2.1	4	3.4	2.6	1.8	1.2
1999-2003, all countries	3.1	3.8	2.4	4.1	4	2.8	2.3	2.2
Cluster 1 (BG,HR,CZ,EE,LV,LT,HU,PL,SK,SI)	3.5	4.3	3	4.2	4.3	3.4	2.9	2.7
Cluster 2 (RO,AL,AM,MK,GE, MD,UA)	3	3.8	2	4.1	4	2.4	1.8	2
Cluster 3 (AL,BA)	2.2	2.6	1.7	4	3.1	2.3	1.3	1
Cluster 4 (RS)	1.5	3	1.4	3.3	2.1	1.5	1.3	1
1995-1998, all countries	2.7	3.6	2.2	3.8	3.5	2.4	2	1.9
Cluster 1 (HR,CZ,EE,LV,LT,HU,PL,SK,SI)	3.4	4.2	2.8	4.1	4.1	3	2.6	2.4
Cluster 2 (BG,RO,AL,AM,MK, GE,MD,UA)	2.6	3.4	2	3.8	3.7	2.3	1.6	1.7
Cluster 3 (BA,RS)	1.1	2.5	1.1	2.7	1.5	1.2	1	1

1991-1994, all countries	1.6	2.6	1.6	3.4	2.7	1.7	1.3	1.5
Cluster 1 (SK,PL,HU,CZ)	2.4	3.4	2.6	4.1	3.8	2.6	1.8	2.3
Cluster 2 (SI,LT,LV,EE,BG, HR, MK)	1.7	2.8	1.6	3.8	3	1.8	1.3	1.5
Cluster 3 (RO,AL,AM,BA,GE,MD,RS,UA)	1.2	2	1.1	2.7	1.9	1.1	1.1	1.2

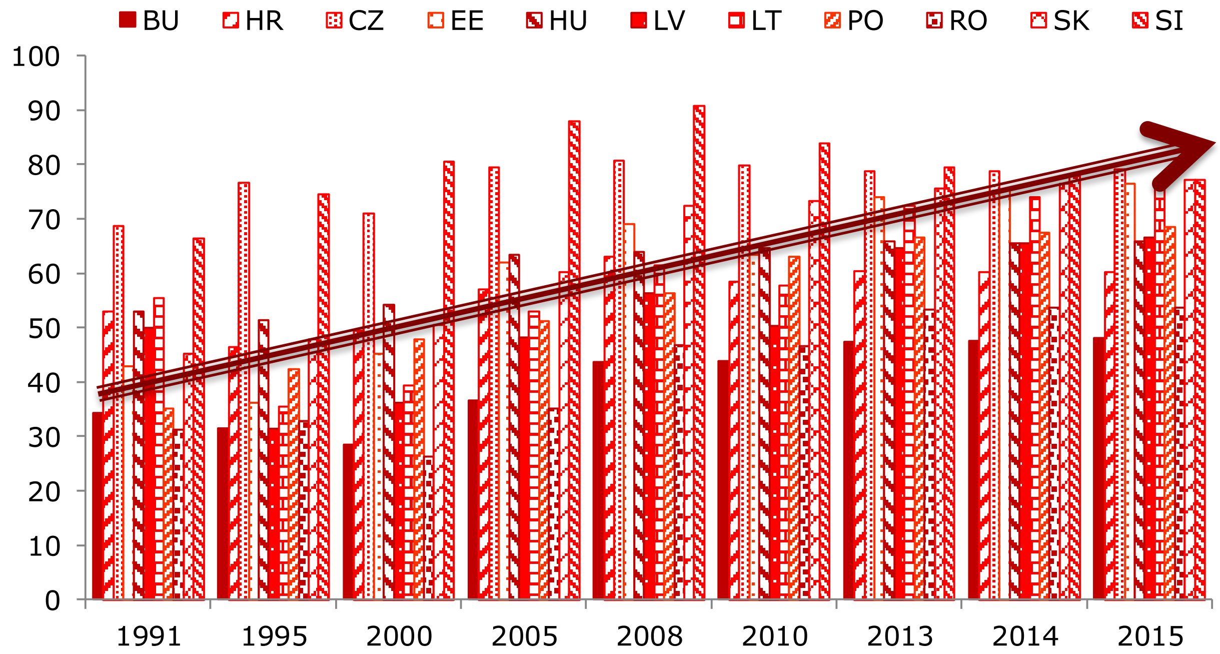
Source: Grusevaja/Pusch (2014), p. 9.

The study reveals that the 'drivers'/'obstacles' of recent institutional convergence are institutions such as competition policy, enterprise restructuring, securities markets and non-bank financial institutions. All of them are necessary for contestable and well-functioning markets, and thus for growth. Despite the effort to speed up the progress of institutional harmonisation in CEECs towards the EU norms in the 1990s, the study did not find a continuous process of institutional convergence. In the data set included, countries have only partly become similar in their institutional settings, creating more or less stable convergence clubs. The probable reason might be the fact that those countries started to transform their institutions towards a market economy at an earlier stage as compared to others. Hence, the institutional development of these countries after 1990 is rather homogenous. Other countries had instead a 'cold start' from very different institutional settings. This means that the initial condition at the start of transition steps should be carefully taken into account instead of implementing a 'best solution'.

In the analysed period, all the new EU member states have made significant progress in institutional transition. In the medium term, institutional convergence towards EU standards positively impacted income convergence in the new EU-member states (Figure 2).

Figure 5

Convergence in the new EU member states



Source: WIIW

5.2 Transition process in China

After more than three decades of economic reform, China has transformed from one of the poorest economies in the world to the second-largest economy, measured by nominal exchange rates; or the number one largest economy in the world measured by purchasing power, which has drawn lots of attention in the media. China has greatly influenced the global economy.

The Chinese transition process started after the great economic experiment by Mao Zedong, the Great Leap Forward (1958-1960), and the ensuing radical political movement, the Cultural Revolution (1967-1976), brought starvation, violence and economic disaster to the country. Both experiments aimed at establishing a new socio-economic and political system close to a socialist regime by de-installing the institution of the family by imposing a communal property rights system, and both failed completely. The economic disaster forced the ruling party to learn from this experience and initiated changes in policies. The transition process in China started in 1978 with the announcement of a new programme for economic development under the slogan of a 'Chinese-style socialist market system' (Yu, 2007: 8-11) that included the following: 1) a move from the collectivised agricultural system to a more anatomic system (private peasant plots); 2) the reduction of centralised economic planning, passing responsibility for acquisition of input and output products and materials to local economic units; 3) encouragement of technological development; and 4) the creation of experimental zones for joint ventures with the aim of attracting foreign capital for economic modernisation. The transition process was characterised by gradual learning and included experiments in the different areas of economic life. The most significant experiments at that time were the agricultural responsibility system, the creation of specific economic zones and, beginning in 1983, the 'dual track' pricing system in state-owned industries (Yu, 2007: 8-11; Raiser, 1994: 2-7).

To sum up, the government reformed the Chinese economy on the mainland without following any model but by an incremental process of trial and error. This gradual approach to transforming the economy had one significant advantage. Chinese citizens could partially retain their old shared mental models while slowly transforming them through learning new ways of doing. The new policies introduced step-by-step in different segments of the economy served as small impulses to the people's thinking and doing. In this way, a new framework evolved as a result of the learning processes, including experiments, failed plans, corrections, adjustments, and innovations. Starting with successful reforms in the rural sector, similar reforms were expanded to the industrial sector and later to the financial sector (Cheung, 1998). The government and Chinese citizens, even the most conservative, participated in this process, slowly giving up communist ideology and becoming involved in market processes. 'A new social stock of knowledge has been steadily built up as these activities are extended to the whole economy' (Yu, 2007: 11). The Chinese transition approach, which included steady governmental learning, avoided big inconsistencies between formal and informal institutions, and the economic performance of the Chinese economy remained high over the entire transition period.

Recently, China has also been facing the challenge of structural changes as growth rates are stagnating from 2012 (Chart 1). State capitalism, as practiced in China, Russia, and many other emerging economies, combines the power of the state with the use of capitalist tools: the state controls access to capital, picks winners, and influences investment decisions, while, at the same time, listing state firms on domestic or overseas stock markets and providing patient long-term capital through sovereign wealth funds. China's state firms account for nearly 70% of China's stock market capitalisation in 2013. The main question is how efficiently state firms allocate capital.

Chen et al. (2005) investigated the efficiency of capital allocation by contrasting how state business groups and privately owned business groups in China allocate capital across their member firms. As Stein (1997) notes, an efficient capital market allocates more capital to units with relatively better investment opportunities. Private business groups induce capital flows from units with relatively worse investment opportunities to units with relatively better investment opportunities. State groups do the opposite. On average, they reallocate capital from firms with the best prospects to the firms with the worst prospects. 'Product market competition and external monitoring by minority private shareholders help discipline state groups' tendency to allocate internal capital inefficiently. Minority shareholders in SOEs that transfer capital to sister firms despite having better investment opportunities themselves earn significantly lower risk-adjusted returns and so are harmed' (Chen et al., 2015, p. 2).

The major institutional problem in China is the difficulties for private firms to enter and to grow in many economic sectors due to institutional barriers and discriminations against the private sector. Because of this institutional problem, state-owned firms obtain most of the resources from the government, which reduces the overall capital productivity in the country.

6 Perspectives of economic governance in Belarus

In recent years, the economic governance has aimed to maintain the status quo. In a medium-term perspective, the Belarusian economy appears to be at a crossroads between the status quo and a new economic governance approach leading to a more sustainable growth pattern. However, the reform steps should be chosen and adopted in accordance with existing 'initial' conditions. The key issues to be addressed:

- Fiscal discipline;
- Gradual privatisation of SOE to reduce burden on budget;
- Governmental investment programmes to increase technological readiness;
- Increase of good market and labour market efficiency through introducing competitive elements/ competition;
- Economic surveillance to encompass long-term sustainability and international competitiveness.

A new economic governance approach based on these elements might be elaborated upon in future work.

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