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## **Improving the Management of State-Owned Enterprises in Belarus**

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# Improving the Management of State-Owned Enterprises in Belarus

## Executive Summary

Belarus follows a rather unique development path of a “state-run market economy”. This model proved to be quite successful over the previous decade, with economic growth regularly in the 8-10% range p.a., but quickly lost its steam in the aftermath of the Global Financial Crisis of 2008/2009. Over recent years, growth in the range of 1-2% became the new reality for the country, which seems far too low given its economic potential of the country.

It thus seems that the specific model Belarus followed in the past has reached its limits. Therefore, it is time to reconsider it and to make some changes that might kick-start new engines of growth. Since the role of state-owned enterprises (SOEs), which are responsible for about 70% of economic activity, is of crucial importance for the country, this is a natural starting point of our analysis.

Based on a thorough assessment of the role of SOEs in the economy of Belarus, we describe the different ways the public sector supports such companies and discuss the efficiency of this support. We then provide an overview of the multiple functions SOEs provide, which go far beyond narrow commercial objectives. The current sole focus on export performance in targeting SOE support is too narrow and likely to perpetuate inefficiencies. It should be given up in favor of a broader, more differentiated approach, for which we have developed a corresponding decision tree. Such an approach should begin with a clear separation of functions and their individual assessment. The state as a shareholder is not identical to a private one, but must take a more comprehensive view. Beyond pure profitability motives, all effects on society (positive as well as negative) have to be taken into account, including spill-overs (e.g. research and development, infrastructure) and other externalities.

Where the overall assessment of an SOE’s activity delivers a positive result, it should be continued. Where marketable activities are concerned, privatization should be considered.

Where the result is negative, restructuring and reforming the business has to be considered carefully. For activities that are likely to be a continuous drag on economic and social performance over the long run, an exit strategy should be devised. In such cases, an active industrial policy should work hand-in-hand with such an exit strategy, helping to attract private investments, foreign as well as domestic, in the regions affected, in order to cushion any temporary negative effects.

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## Contents

1. Introduction .....	1
2. The role of state-owned enterprises in the economy of Belarus.....	1
3. Public support to the SOE sector.....	4
3.1 Instruments of support .....	4
3.2 The scale of public investments.....	6
3.3 Efficiency of public support.....	7
4. Improving the management of SOEs: Moving beyond corporate profit maximization .....	8
4.1 Sole focus on exports?.....	8
4.2 Employment .....	8
4.3 Spill-overs/external effects.....	10
4.4 Social infrastructure .....	11
4.5 Taxation.....	11
4.6 Monopoly power.....	12
5. Policy recommendations .....	13
References .....	16
Annex: Public investments.....	17

## 1. Introduction

Over 20 years after the shift from a communist system to a market economy, the economic structure of Belarus is still dominated by the state. According to a recent estimate by the European Bank for Reconstruction and Development (EBRD), 70% of the country's economy is state-controlled<sup>1</sup> – this makes Belarus an outlier among European nations. And while this rather reluctant and gradual approach towards free markets may have worked for Belarus until recently, the odds are that its economic model may have already reached its limits and are increasing. A lack of competition and the unilateral orientation towards the Russian market have not helped to develop an internationally competitive structure of industrial production and services; increasingly, the relatively basic and often out-of-date products Belarus has on offer are falling behind the curve<sup>2</sup>.

Thus, there are clear signs that the Belarusian model of achieving economic growth on the basis of broad-scale public ownership and intervention is reaching its limits. Currently, it is hard to see that the pattern of government intervention in the economy should deliver any further positive long-term effects – right to the contrary, it seems to have become rather an impediment to future economic growth. Hence, there is an obvious need to review Belarus' public investment policy, in order to sharpen its focus on the promotion of prosperity and economic growth, while at the same time retaining the level of public infrastructure and social security that Belarus provides to its citizens. In the present paper, we attempt to provide a critical assessment of the way the state as a shareholder manages its enterprises, coupled with selected recommendations on how the management could be improved.

The paper is structured as follows: In the following chapter 2, we will provide a short overview of the role that state-owned enterprises (SOEs) play in the economy of Belarus. Chapter 3 is devoted to a more thorough analysis of the way the state supports its enterprises in terms of scale of public support, instrument use and an assessment of its efficiency. In chapter 4 we provide some general ideas that should be taken into account when managing SOEs, since the state as shareholder has a specific focus, which is not always identical to a private one. We conclude in chapter 5 with some policy recommendations.

## 2. The role of state-owned enterprises in the economy of Belarus

The economy of Belarus is characterized by a dominant government sector, which makes it an exceptional case among the economies in the region. While the other countries of Central and Eastern Europe after the fall of communism have privatized on a large scale, in Belarus the share of the private sector in the economy is estimated to be only around 30%<sup>3</sup>. According to the World Bank, in 2010 SOEs controlled 55.5% of the output in Belarus, and 54.5% of valued added (Favaro, Smits, Bakanova (2012)). The share in employment and fixed capital investment was even higher, amounting to 65.6 and 66.2% respectively. On the contrary, the share of SOEs in

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<sup>1</sup> EBRD, Structural Change Indicators, <http://www.ebrd.com/downloads/research/economics/macrodata/sci.xls>.

<sup>2</sup> The World Bank in a recent report points to the on-going reorientation of Russian demand towards more sophisticated imports from Western Europe, but also from, e.g., China. See Favaro, Smits, Bakanova, (2012).

<sup>3</sup> EBRD, Structural Change Indicators, <http://www.ebrd.com/downloads/research/economics/macrodata/sci.xls>. - These estimates, however, are only indicative. The true scale of state participation in the economy is masked by statistics that report corporatized enterprises as private, even when the state is still the major (or only) shareholder.

merchandise exports was “only” 45.8%<sup>4</sup>. SOEs are playing a dominant role in industries like machine building, construction, transport and communication, chemicals, and oil refining. It is estimated that SOEs’ share in output of these sectors exceeded 70% in 2010.

Official statistics provide a similar picture. According to Belstat, SOEs and enterprises of mixed ownership (without foreign ownership) contributed 67.3% of total industrial output in 2010 (see Table 1). In 2013, the figure had dropped slightly, to 60.3% of industrial output (a figure that might be underestimating the reality, however).

And while it is only a minority of companies in Belarus that is fully state-owned (see Table 1), SOEs differ substantially from other enterprises with respect to their size. In 2010, enterprises fully owned by the state employed on average around 440 people. In sharp contrast, private companies established by judicial persons employed less than 30 people on average; for individually owned private companies, the figure is below 10. In other words, Belarus’ economic structure is dominated by a relatively small number of big state-owned companies, while the private sector is characterized primarily by small and medium-sized enterprises (SME), which even taken together only hold a minor share in output and employment.

**Table 1**

Structure of industrial employment and output by type of ownership, 2010

	<b>Number of companies</b>	<b>Output (BYR bn)</b>	<b>Employment (Persons)</b>	<b>Output per company (BYR bn)</b>	<b>Employment per company (Persons)</b>
<b>Total</b>	<b>15,028</b>	<b>165,214</b>	<b>1,059</b>	-	-
state ownership	3.8%	22.1%	23.8%	63.9	441.4
mixed ownership (without foreign ownership)	5.4%	45.2%	42.4%	92.0	553.3
private (owned by individuals)	39.3%	2.1%	5.4%	0.6	9.7
private (owned by firms)	41.6%	10.5%	16.3%	2.8	27.6
foreign capital	3.3%	2.6%	2.8%	8.7	59.8
mixed ownership with foreign capital	6.6%	17.5%	9.3%	29.2	99.3

*Note. Data for 2010 are the latest available numbers for employment in the provided breakdown. Source: Belstat*

Given this structure of a highly concentrated government sector<sup>5</sup>, it is straightforward that production is widely monopolized and there is little competition in the market. Moreover, they also operate under privileged conditions in external markets, as they still maintain strong networks with counterparts in the former Soviet Union. Under these circumstances, until recently Belarus’ SOEs were able to sell low-price, low-technology products on both domestic and CIS markets (see Favaro, Smits, Bakanova (2012)).

<sup>4</sup> It may be explained by petroleum products export schemes, where final exporters are reported to be SMEs.

<sup>5</sup> In 2013, just the three largest enterprises taken together stood for more than 20% of total manufacturing in the country.

Another characteristic of Belarus' SOEs is the far-reaching vertical integration of production chains - which partly explains their huge size as compared to the private sector<sup>6</sup>. The logic behind this vertical integration is to maintain control over the supply chain and guarantee the quality of intermediate goods. Moreover, from an economic policy view, it simplifies the channeling of support to the enterprises. At the same time, though, this approach also facilitates the covering-up of possible inefficiencies and losses along the production chain through cross-subsidization.

Vertical integration shapes economic geography as well. Usually, integrated suppliers are based in the countryside around a city where the assembling enterprise is located. According to Favaro, Smits and Bakanova (2012), this structure is not without problems. In order to meet the demand of the often huge assembling plants, suppliers themselves have to be rather large in relation to the local labour market. In consequence, the labour market of small towns often fully depends on the survival of just one company.

Issues arising from the absence of competition and the dominant role of SOEs in the economy are being addressed by the government through extensive interference and regulation. As a result, SOEs have to meet additional goals on top of just making profits. The state (through different agencies) sets targets related to, e.g., volume of production, employment, or investment, thus limiting the flexibility of SOEs. In times of crisis, this can lead to rapid inventory accumulation (with associated financing cost) and result in huge losses. At the same time, there is a permanent problem of excessive employment and over-investment. Research by Cuaresmo, Oberhofer, and Vincelette (2012) revealed that SOEs in the machine-building industry employ almost 50% more workers than comparable private companies, and that they have twice the amount of capital on their balance sheets.

Overemployment, however, is also a consequence of the social functions that SOEs fulfill. Belarus' social security system currently does not address the problem of unemployment, as the official unemployment rate is only about 0.5%. And although this extremely low figure partly is mirroring the absence of incentives to register as unemployed, the real unemployment rate is also rather low (around 6%, according to census data). This is achieved, however, not through a vibrant private sector, but by guaranteeing maximum possible employment in SOEs (Shymanovich (2010)), and through regulating the dynamics of wages. As a result, SOEs are left with an inefficiently large and relatively unproductive stock of employees. Besides, SOEs often also provide social services to their employees. These may include medical facilities, but also catering or even summer camps for children.

Operating in a heavily regulated environment shielded from competition, and at the same time burdened with overemployment and social functions, SOEs have neither strong incentives nor much maneuvering space to improve their competitiveness. Still, they are vulnerable to changes in the external environment. Shifts in Russia's demand structure towards goods of higher quality led to a dramatic fall in Belarus' share in the Russian market for industrial products (see Chubrik (2013)). This problem is exacerbated by Russia's current economic crisis, which leads to an overall fall in its investment demand. Furthermore, Russia's WTO accession curbs privileges that Belarusian enterprises had as they were operating under the regional integration agreement of a Common Economic Space.

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<sup>6</sup> Currently, there is even a tendency for SOEs to become bigger yet, through horizontal integration: enterprises are being integrated into holdings, in order to coordinate activities on export markets.

As a consequence of these structural weaknesses, the state has to provide support to the sector. This is done through soft budget constraints including public procurement (largely for the needs of agriculture), procedures where SOEs have privileged conditions, tax privileges (for the agriculture sector), and broad investment support aimed at modernizing the real sector. While the costs of this support are very high, the outcomes are questionable at best, which fuels discussions over the necessity to increase the efficiency of state support to the real sector.

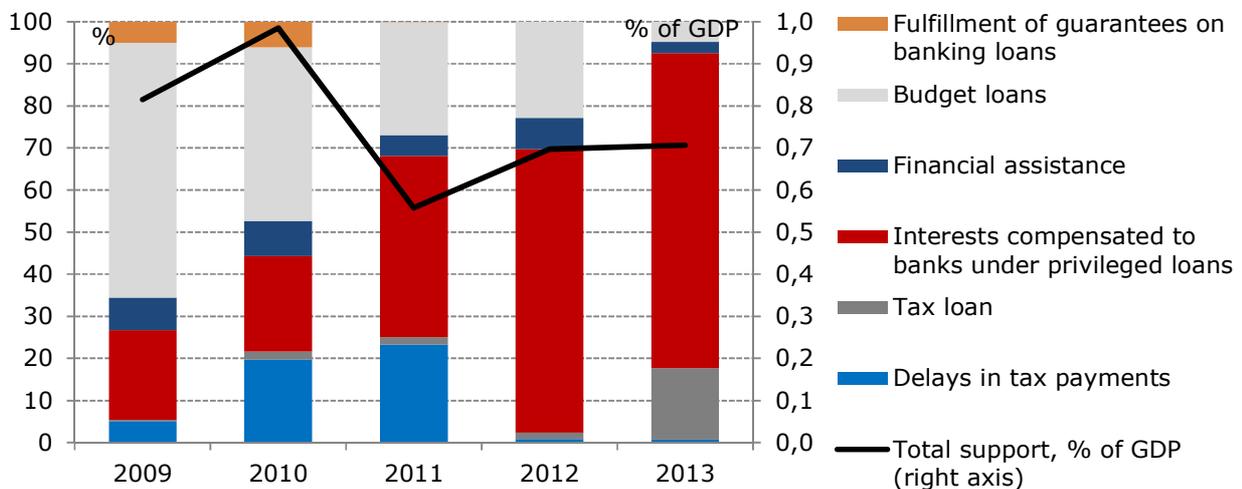
### 3. Public support to the SOE sector

#### 3.1 Instruments of support

The state is using several channels to influence the performance of SOEs by improving their financial stance and promoting investment. Support to the real and financial sector is provided in the form of direct subsidies, delays in tax payments, budget loans, guarantees on banking loans, coverage of interest rates for banking loans and recapitalization of state banks. However, the scale of these interventions had to be reduced substantially with the recent global financial crisis (Haiduk (2012)). Official data on the support given to the real sector from the central government budget reveals that today the key instrument is the compensation paid to banks that provide privileged loans to enterprises, while the role of other instruments has shrunk considerably (see Figure 1). By and large, apart from direct public investment, central government support to the real sector is currently reduced to covering costs of directed lending, which implies that the focus of the government is on the stimulation of investments.

**Figure 1**

Structure and volume of public support to real sector from central government budget



Source: Ministry of Finance

For direct public investment financing, the government uses tools such as the state investment programme, so-called "innovation funds", and other programmes (for details, see Annex 1). These tools target different areas, but their main focus is on investments either in infrastructure or in innovative technologies. They receive substantial funding not only from the central government, but also from local budgets (and, in the case of the "innovation funds", from profitable enterprises themselves).

This direct financing of government programmes is complemented by additional funding from the financial system, in the form of “directed lending”. A key player in this regard is the Development Bank, which was established in 2011 with the explicit task to finance investment projects and leasing operations carried out within state programmes<sup>7</sup>. At the same time, however, it is recommended that commercial banks (state-owned as well as private) participate in the financing of state programmes. In 2014, commercial banks are expected to contribute BYR 24.9 tn (EUR 1.8 bn), as compared to BYR 27.8 tn (EUR 2.1 bn) that come from the central government’s budget.

**Table 2**

Planned public sector support to investments in 2014

	Central government budget		Local government budget		Development Bank loans		Commercial Bank loans	
	BYR bn	% GDP	BYR bn	% GDP	BYR bn	% GDP	BYR bn	% GDP
Innovation funds	779.1	0.1	(no data)	(no data)				
State investment programmes	5,681.1	0.8	7550.8	1.1				
State programmes, not financed from state investment programme or innovation funds	21,352.8	3.0	(no data)	(no data)	6,195.2	0.9	24,884.8	3.5
Not related to agriculture					3,676.8	0.5	10,874.7	1.5
Agriculture and food industry					1,469.0	0.2	10,298.0	1.5
Dairy farms					1,049.4	0.1	3,712.1	0.5

Source: Own estimates based on legislation

<sup>7</sup> Edict No. 261 from 21.06.2011 “On establishment of JSC Development Bank of the Republic of Belarus”.

### **Box: The Development Bank of the Republic of Belarus**

The Development Bank of the Republic of Belarus was established in 2011. The institution was set up in order to make the process of directed lending more transparent and address the problem of “toxic assets” in the banking sector.

The Bank provides financing in the form of privileged loans or through the acquisition of bonds issued by Belarusian companies. Priority is being given to projects from agriculture and the food industry, infrastructure projects, innovative projects aimed at export growth, and large-scale projects in key sectors of the economy. Loans are to be granted only to solvent borrowers. Therefore, the Bank analyses the effectiveness of proposed projects based on general criteria applied within state programmes, as well as its own financial criteria. Moreover, it assesses the sufficiency of the funding requested and the risks of loan repayment.

According to the plan for 2014 set in decision No. 264 of the Council of Ministers, the Development Bank is expected to support 73 projects within state programmes and of an estimated worth of BYR 6.2 tn (EUR 458 m). The vast majority of these projects (61) are related to agriculture and food production, with a special focus on the dairy industry.

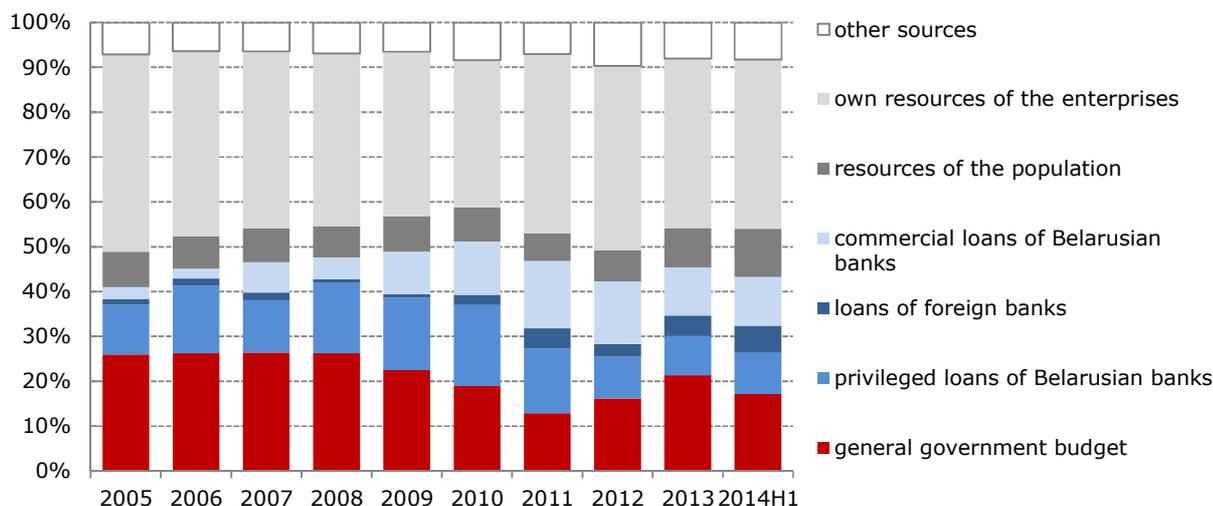
### *3.2 The scale of public investments*

The broad range of government involvement in investment is reflected in these activities’ share in the economy. The total volume of investments planned by the government in the form of public investments or directed lending for 2014 exceeds 8% of GDP (without local programmes, see Table 2). This implies a crucial role of the public sector in the determining dynamics of capital formation. General government expenditures and directed lending were even more prominent in investment financing for much of the last decade (see Figure 2); around 40% of total investments were financed or supported with taxpayer’s money in 2006–2010.

Afterwards, though, its share in the sources of investment financing declined significantly. The economic crisis of 2011 forced the government to reduce public capital expenditures. Furthermore, beginning already in 2009, changes in the conditions of the oil trade with Russia and a new Stand-By Arrangement with the IMF enforced fiscal tightening. Still, as the real sector does not show clear signs of revival in 2014, and market interest rates remain high, the government budget is likely to remain an important source of investment financing over the short and medium term.

**Figure 2**

Structure of the sources of the investment financing



Note. Privileged loans for 2005 – 2009 are estimated based on loans provided to the agriculture sector and long-term loans provided to the population.

Source: Belstat, IPM Research Center estimates

### 3.3 Efficiency of public support

Despite its large scale, and also in spite of recent attempts to target support for research and innovation, the government's investment activities have not been accompanied by productivity gains. Belarus' long-term growth potential has been falling steadily, down to currently 1.3-3.5% (Kruk (2014)). Therefore, it seems in order to question the effectiveness of public investments conducted so far, as well as the mechanisms for their selection. While it has been frequently pointed out that disincentives resulting from low utility tariffs (World Bank (2011)) and a lack of effectiveness of social expenditures (World Bank (2013), Kruk and Shymanovich (2011)) leave room for improvement, the most pressing problem is the lacking efficiency of public investments into the real sector. Agriculture enjoys huge public support, but a big share of agricultural enterprises remains loss-making (World Bank (2011)). The industrial sector, benefiting from different types of public support (Haiduk (2012)), does not generate vibrant economic growth. Machinery and transport production stagnates due to the low competitiveness and the falling investment demand in Russia. Overall, Belarus' economy gives more of a picture of stagnation rather than catching up with its more prosperous neighbors these days.

The core of the problem is the fact that extensive public support and interference has helped to preserve the existing structure of the economy, hindering the mobility of both the labor force and capital. Bornukova and Kruk (2013) prove that ineffective resource allocation, caused by a low mobility of capital, is a key factor that suppresses total factor productivity in Belarus. Their result is in line with World Bank research showing that the productivity of state-owned enterprises is lower than in the private sector, and is constrained by excessive employment and capital formation (Cuaresmo, Oberhofer and Vincelette (2012)).

The efficiency of indirect state support to investments in the real sector through directed lending is difficult to assess, due to a lack of data. The World Bank's (2009) Public Expenditure and

Financial Accountability (PEFA) report stresses that quasi-fiscal activities are a key problem hindering the transparency and accountability of public finances in Belarus. However, empirical research into the matter that has been attempted by Kruk and Haiduk (2013) provides arguments that directed lending is likely to have a negative influence on long-run economic growth in Belarus.

#### **4. Improving the management of SOEs: Moving beyond corporate profit maximization**

##### *4.1 Sole focus on exports?*

While the lack of efficiency of Belarus' SOEs is a major challenge for the country's economic prospects, not all SOEs are necessarily unprofitable or without any growth perspectives. Current policy is aware of this, and there are attempts to target support to promising enterprises. However, the selection criteria as used at the moment are not suitable to properly assess these perspectives, or even long-term profitability.

Currently, the assessment of SOEs is practically based on their export performance. At first glance, such a focus looks reasonable in a country with persistent external deficits and a history of repeated currency crises. However, achieving success on export markets primarily with the help of subsidies (official or hidden) is not a sustainable strategy.

First of all, pure orientation on exports tends to ignore the underlying cost structure. Non-market incentives can lead to management decisions that are questionable from an efficiency perspective (e.g., production for export markets replaces more efficient activities for the local market). In extreme cases, export success through subsidies might even be loss-making; in any event, subsidies might be used to cover up inefficiencies.

Additionally, over the long run, the country would be better off with free, instead of distorted, trade. At the same time, as long as the exchange rate is not fully determined by the market, but managed, short-term success on export markets is a questionable indicator for long-term competitiveness and profitability.

On top of all this, it should be kept in mind that different SOEs have different functions. Many provide goods that are not equally suitable for export (for example, the distribution networks of utilities), still they can be run efficiently and justify additional investment.

For all these reasons, the concentration on exports in the assessment of SOEs is too narrow. Where policy is focusing only on exports, it might well overlook opportunities in the domestic market, and forego profits that any private sector management would not hesitate to seize. As a first step, therefore, the perspective should be broadened and see SOEs as businesses, not just as suppliers of foreign currency. As an entrepreneur, the government will have to make investment decisions, hire or lay off staff, and sometimes even consider closing down a line of activity.

Secondly, however, even as entrepreneurs, governments are still governments and they have to consider a range of arguments in their decisions that do not matter for the private sector.

##### *4.2 Employment*

As a first case in point, decisions that affect employment have to be assessed differently by governments. From the perspective of private businesses, laid-off workers simply disappear from

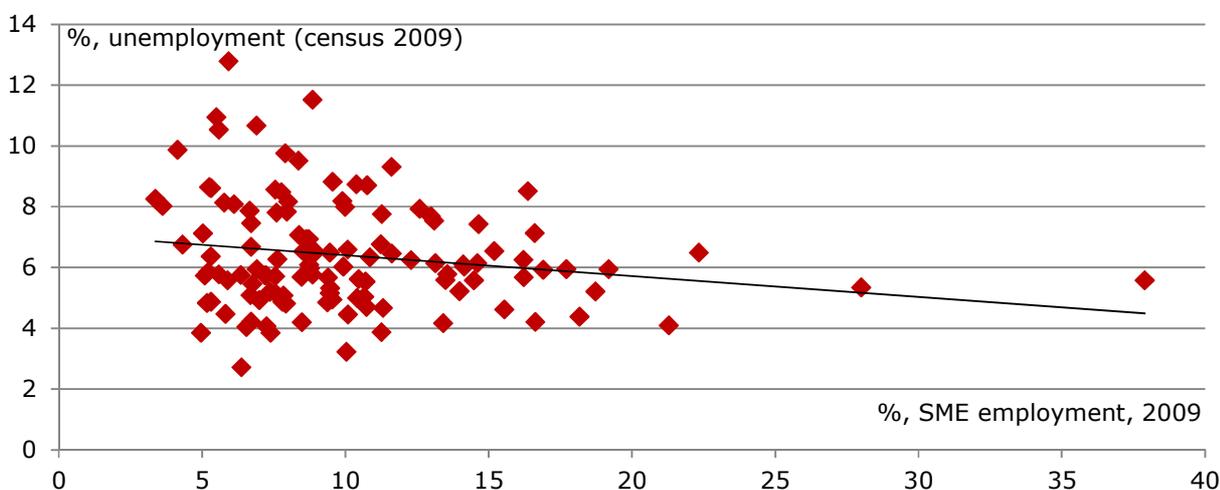
the balance sheet, independent of the current demand for workers in the market. For the public sector, though, conditions in the local labor market matter a lot. If the labor market is weak, and a large number of laid-off workers face a prolonged period without a job, the public will have to bear the costs of unemployment (in the form of benefits paid as well as foregone tax revenue). Moreover, non-monetary costs of unemployment (such as social disintegration), as well as possibly undesirable distributional effects, should be taken into account by a welfare-oriented government.

This is not to say that unproductive public sector employment should be perpetuated indefinitely, but it does imply that it should make a substantial difference for decision-making whether laid-off workers have a perspective of quickly finding new jobs, or whether they face long-term unemployment.

In Belarus, where SOEs tend to play a role of “employer of last resort”, this problem is especially pressing. Where SOEs lay off workers, or, in the worst case, close down, this is very likely to lead to long-term unemployment, as little alternative job opportunities are available. Only where a developed private sector exists, usually in the form of SMEs, this risk is being mitigated. Census data of 2009 and statistics on SME show a negative correlation between the share of the SME sector in employment and the unemployment rate. However, the development of SMEs in turn is constrained by the presence of large SOEs, as they erode any competitive environment. As Chubrik et al (2014)<sup>8</sup> show, there is a significant negative correlation between industrial concentration in a region and the size of the SME sector.

**Figure 3**

Unemployment and private sector development interrelation



*Note. SMEs are a good proxy for private sector, as the average private industrial enterprise is an SME (see chapter 2), while the share of state-owned enterprises in SMEs is just 2%.*

*Source: Belstat*

Therefore, in the restructuring of SOEs with low labor productivity, locations should be prioritized that already have developed a vibrant SME sector. At the same time, favorable conditions for

<sup>8</sup> Chubrik A. (2014). What Policy Can the Belarusian Economy Sustain, Discussion Paper of the IPM research Center DP/14/01.

employment generation in the private sector should be supported actively in regions that up to now have been dominated by big SOEs, especially where an excessive size of the workforce is a pressing issue.

#### *4.3 Spill-overs/external effects*

Regarding big SOEs, external effects are another issue that should be of concern for government decision makers.

When enterprises are large, they affect the surrounding economic (and social) landscape: they generate spill-overs. These can take a wide variety of forms – there may be infrastructure that has been set up to support a large production plant, but is used also by smaller firms and the general public, there may also be “cluster effects” that attract other producers along the same value chain (thus creating additional employment opportunities), they might also provide the “critical mass” for the establishment of all kinds of services. Moreover, certain business activities (e.g. research and development) come with positive external effects that are of use for the economy as a whole.

At the same time, though, external effects may also be negative. The costs (monetary as well as non-monetary) of pollution, noise, etc. have to be borne by the society (if they are not “internalized” by carefully calibrated fees and taxes).

And when things go bad, the sudden loss of a big employer (and the fall in overall demand that comes along with it) has implications for the local economy, at least over the short and medium term.

All these benefits and costs are not taken into account by a private sector manager. They should, however, enter the calculation of a governmental decision maker.

In Belarus, SOEs are vertically and horizontally integrated, which makes them dominant players in local markets and sets the stage for substantial spill-overs and external effects. Especially cluster effects are clearly visible (within and outside of large SOEs): where local demand is dominated by one big production plant, suppliers adapt and develop networks, skills and specific services. Maintaining and fostering such clusters may therefore justify a targeted industrial policy, at least for a certain period of time before positive externalities become self-reinforcing.

As to positive spill-overs from R&D, they are supported by a wide range of tax deductions, including import duties reductions for equipment imported for R&D, profit tax reductions for innovative organizations, VAT abolishment, etc. However, as of now, the primary effect of these privileges is additional import of machinery and equipment labeled as innovative (acquisition of equipment constituted 63.1% of total expenditures on technological innovation in 2013, while expenditures on R&D accounted only for 6.3%). This calls for a critical review and better targeting of support for research and development. Only where other actors in the economy benefit from the R&D activities of one enterprise, there is scope for targeted public support. Otherwise, the procurement of equipment should be a pure business decision and not being influenced by government intervention.

Negative external effects that affect the environment are taxed by an ecological tax in Belarus. Its tax base includes emissions, discharge of sewage waters, waste, import of ozone-depleting

substances, and extraction of natural resources<sup>9</sup>. Although such a regime clearly goes into the right direction, though, there is evidence that current rates are too low to make business bear the full costs of environmental damage they cause. Therefore, as long as there is not enough political support for a re-design of the tax scheme, public decision makers will have to assess the ecological impact of their activities separately and ensure that, while making a profit on the business side, they do not inflict harm at a disproportionate scale on the wider public.

#### *4.4 Social infrastructure*

While private businesses focus on profit-generating activities, state-owned enterprises often fulfil additional functions that follow from the government's role as a provider of social services. Specifically, in formerly socialist countries state combines, in addition to their productive core activity, used to provide facilities as diverse as childcare, hospitals, schools, and even restaurants. And also today, many SOEs are perform activities that have little to do with their line of business, but are essential for the well-being of the local community. Moreover, they may be active as sponsors of cultural and social events.

Many of these activities are practically not marketable (especially where they cover basic needs of low-income workers and their families), which makes them "classic" government activities – even where these functions are carried out by the private sector, they usually involve high subsidies and are heavily regulated. When assessing SOEs, therefore, these activities should not be expected to be profitable, and at the same time, they should not be allowed to blur the picture when it comes to the balance sheet of the core business.

Belarus' SOEs are no exception here – many of them provide essential services, not only to their workers, but also to local residents in general, far beyond their core business activities. And while many of these activities are productive in the sense of their contribution to over-all welfare, they might still incur losses from a pure business perspective. Therefore, in order to allow for a sober assessment both of the social services as of the core business, the accounts of these lines of activity should be clearly separated and all cross-subsidies made visible. Such a separation of functions is essential as a basis for proper business decisions, and, by the same token, for an unbiased analysis of costs and benefits of social activities.

#### *4.5 Taxation*

In the private sector, the central criterion for success or failure is operating profit after taxes. From the government's point of view, however, taxes are part of the income an enterprise generates, so the government's focus should be on the company result before taxes. Where an incentive-compatible tax system (that doesn't distort economic activity) is in place, both criteria are equivalent, but in practice, taxation tends to influence decisions and outcomes in the private sector. Especially where taxes are non-proportional, or even lump-sum, initially profitable activities can become unattractive for private entrepreneurs.

Therefore, while a private company would just close down a loss-making line of business, the government should be careful – where only taxation makes an SOE's profits disappear, it could be

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<sup>9</sup> There are, however, some exemptions from this tax, including budget organizations and agricultural firms operating under a simplified tax regime.

that it is still profitable for the government if all income it generates are aggregated. In general, business decisions by SOEs should not be based just on tax issues.

In Belarus, corporate taxation is a proportional share of profits and does not distinguish between enterprises by their ownership structure. Privileges or additional surcharges are provided based on the sphere of activity (R&D, agriculture, gambling, financial sector, etc.). Special regimes are provided for SMEs, residents of free economic zones, technical parks, hi-tech parks, enterprises registered in small towns, and in rural areas. Furthermore, SOEs (with the share of the state exceeding 50%) pass a part of their profit to the budget at the rate of 5–20%, depending on the sphere of activity). And where foreign investors come into play, there is the practice of concluding an “investment agreement”, which may include any kind of tax privilege.

As long as all these different arrangements do not compromise on the basic principle of proportional profit taxation, though, decision-making can be left to the business side. Where an activity is profitable before tax, it will still be profitable after tax, and government will receive its due share, regardless of the business being private or publicly owned.

However, SOEs officially regarded as highly profitable are subject to additional lump-sum surcharges into the National Development Fund. Such lump-sum payments have to be handled with special care, as they have the potential of turning profitable activities into loss-makers (for example, it might be unattractive for an SOE to move up into the “highly profitable” category, and thus it could be discouraged from undertaking otherwise promising activities). It should be considered whether this lump-sum surcharge can be modified into a proportional levy that would not distort business decisions.

#### *4.6 Monopoly power*

SOEs often have a strong position in the local market – either for historical reasons, or because they possess “natural monopolies” (such as electricity grids, railway networks, etc.), which are not suited for free-market competition. If such monopolies are in a profit-maximizing way, this is detrimental to overall welfare (as prices are set higher than they would be in a competitive market). Moreover, sometimes governments use certain natural monopolies (electricity, gas, local transport) in place of a welfare system, to organize redistribution and cover basic needs.

Monopolies, therefore, bring a political challenge. From a good governance perspective, when they are privatized, they have to be either split up (in order to ensure competition), or to be heavily regulated (where natural monopolies are concerned). Therefore, where a functioning market solution cannot be achieved, it may be better to run monopolies as public enterprises, but not in a profit-maximizing way. Instead, prices and quantities should be set at a socially optimal level.

In Belarus, infrastructure is largely state-owned (partly, the telecommunication sector forms an exception), and the progress of reforms is considered to be very low, according to an EBRD assessment<sup>10</sup>. One of the issues frequently raised is widespread cross-subsidization between households and enterprises (and also between sectors of the economy), through tariffs for heating, electricity, transportation, etc. While these subsidies distort incentives for consumers and induce waste of resources (especially energy), though, they are an essential part of Belarus’ system of redistribution of income. Thus, a liquidation of cross-subsidies would inflict hardship on

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<sup>10</sup> EBRD, Transition development snapshots: <http://www.ebrd.com/downloads/research/economics/macrodatab/sib.xls>.

a substantial share of the population (see Chubrik, Shymanovich (2013)). A reform of utility pricing addressing these issues, therefore, should not target profit maximization of the state-owned monopolies involved, but rather devise a balanced scheme of pricing, subsidies, and direct social transfers, that takes into account all the complex welfare effects involved.

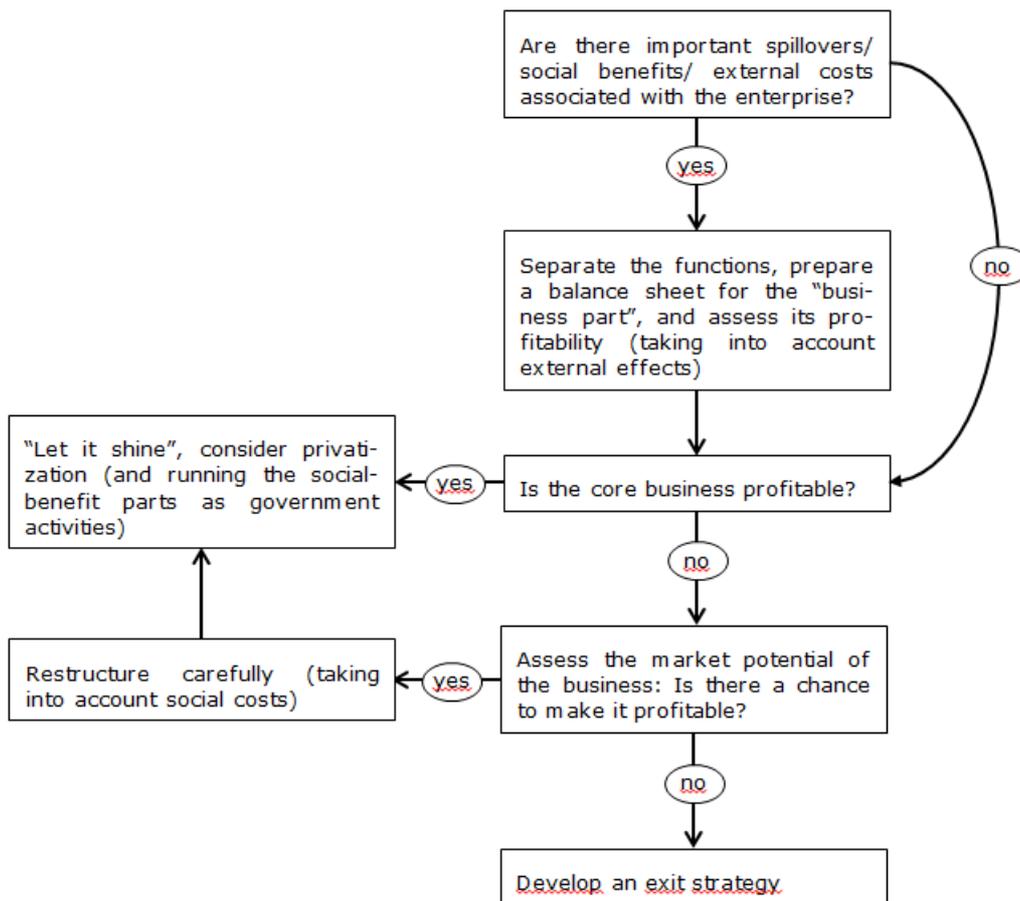
### 5. Policy recommendations

After more than a decade of a strong economic growth performance, Belarus’ model of economic and social development is showing signs of exhaustion. Therefore, in order to unleash new forces for innovation and growth, it will be indispensable to re-assess the performance of large state-owned enterprises, which are currently still dominating the structure of the Belarusian economy, and to improve their management.

Steps towards this direction cannot be taken, however, without a proper assessment of the SOEs in question and the multiple functions they fulfil in the economy as well as for society as a whole. The following decision tree provides an outline for a structured approach to make such an assessment.

**Figure 4**

Decision Tree on Strategic SOE Assessment



Source: Own display

Instead of judging the performance of SOEs solely by their success in export markets, all functions of a given SOE should be looked upon separately. Where it is possible to single out a **marketable core business**, this should be assessed carefully for its profitability, taking into account all **spill-overs** and **externalities**. If this core business is profitable under market conditions, it is not advisable to use it for the cross-subsidization of social functions taken over by the SOE, or to cover up losses incurred by other activities. Instead, it should be allowed to exercise its potential and further develop its position in the market; **privatisation** is an option that can and should be considered. Functions that are not profitable from a business perspective, but still of worthwhile value to society, can be organizationally separated, even if they remain under the umbrella of the SOE for the time being, and financed with the help of direct government funding.

A special case are SOEs which run **natural monopolies**, primarily the infrastructure for transportation, energy and (to a certain extent) communications. As has been shown, these enterprises should not be run like businesses in competitive markets, but rather in a fashion that balances efficient service provision with other policy goals, such as availability of access and concerns over redistribution.

There are, however, cases where the core business is not in a condition to be successful in a competitive market, even once social functions have been separated and spill-overs are compensated for. In such situations, it may be tempting to leave structures as they are and use policy tools like subsidies or protection against competition to compensate for inefficiencies – specifically, where they come in the form of over-employment. This kind of response, however, is a **recipe for stagnation**. In the long-run, development is impossible without the reformation of old structures that have become inefficient over time. Therefore, instead of letting unprofitable businesses go on and on at the expense of the taxpayer, it should be assessed to which extent they can be restructured and made profitable. And although that involves hardship and comes at a social cost, lines of activity, and maybe even whole enterprises, that do not have a reasonable perspective for a future in a competitive environment should be phased out, thus freeing up resources for the creation of more promising opportunities.

As the replacement of old industries with new ones does not happen overnight, though, the process of structural change has to be managed carefully. Where large business activities are forced to close down, this should not happen without an individually laid out **exit strategy** being in place. First of all, such an exit strategy should allow for a slow process of phasing out, during which employees receive support in order to develop their capacities and find new jobs and dependent suppliers can re-orientate and diversify their production. Simultaneously, an active **industrial policy** for the region should seek to attract new, **private investment** to make use of the existing infrastructure and workforce. Ideally, new clusters will emerge this way and over time reshape the economic structure of the region.

At the same time, such an exit strategy will have to consider a new structure for the provision of **social services** that have been provided by the SOE in the past, and it will have to take account of the loss of spill-overs (for example, by allowing R&D activities to be carried on in a publicly financed research institution).

Complementary to such individually targeted activities, though, is the setting up of a **basic safety net** for laid-off employees. Once workers that have lost their jobs can rely, at least for a transitional period, on substantial support from the community, the need for structural change in

the economy can be met, providing new perspectives for working families without at the same time putting them at risk of ending up in poverty.

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## **Annex: Public investments**

The government has several instruments that allow it to finance investment projects directly at the expense of the budget:

- State investment programme,
- Innovation funds,
- Other state programmes.

### State investment programme

The state investment programme is aimed at the “development of material and technical facilities of the industries and the social sphere”<sup>11</sup>. It implies that projects supported under the programme are largely focused on the creation and modernization of infrastructure. The projects are selected based on the general criteria of maximum social-economic effects, whose estimation is not specified. The state investment programme has a strict focus on the facilities under Republican ownership. The communal-owned facilities also may be eligible for financing if that is approved by the Presidential Edict, but should be financed partially from central and local budgets.

Most of the financing for the state investment programme comes from the central government budget. This financing is divided into several parts. The “Law on Republican budget” explicitly sets the amount of expenditures of the state investment programme that is covered from the National Development Fund, the Presidential Fund, and from sources allocated to road construction and maintenance<sup>12</sup>. A separate Edict (No. 70 from 20.02.2014) sets the list of projects that will be financed within a year by different sources of finance.

Table A.1 provides an example of the volume and structure of the state investment programme financing based on legislation for 2014. Most expenditures are sourced from the non-specified funds of the central government budget. The projects financed from these sources are diversified, and only a small part of them is related to the financing of real sector investments – investments in agriculture and energy infrastructure (see Figure A.1a). Specified funds of the budget target certain spheres and cover very specific projects (see Table A.1).

Local budgets play an important role in financing public investments as well. Local authorities have their own regional investment programmes that are approved by decisions of local executive committees. The focus of these programmes is on housing and utilities, education, healthcare and other issues of the social sphere. Only specific industrial or service-related projects are financed within these programmes (see Figure A.1b for the structure of the expenditures within Minsk city investment programme).

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<sup>11</sup> Edict No. 299 from 05.05.2006 on “Provisions on the principles of the state investment programme formation, affirmation and reporting of its fulfillment”.

<sup>12</sup> The Road Fund was eliminated in 2008.

**Table A.1**

Volume and sources of state investment programme financing in 2014

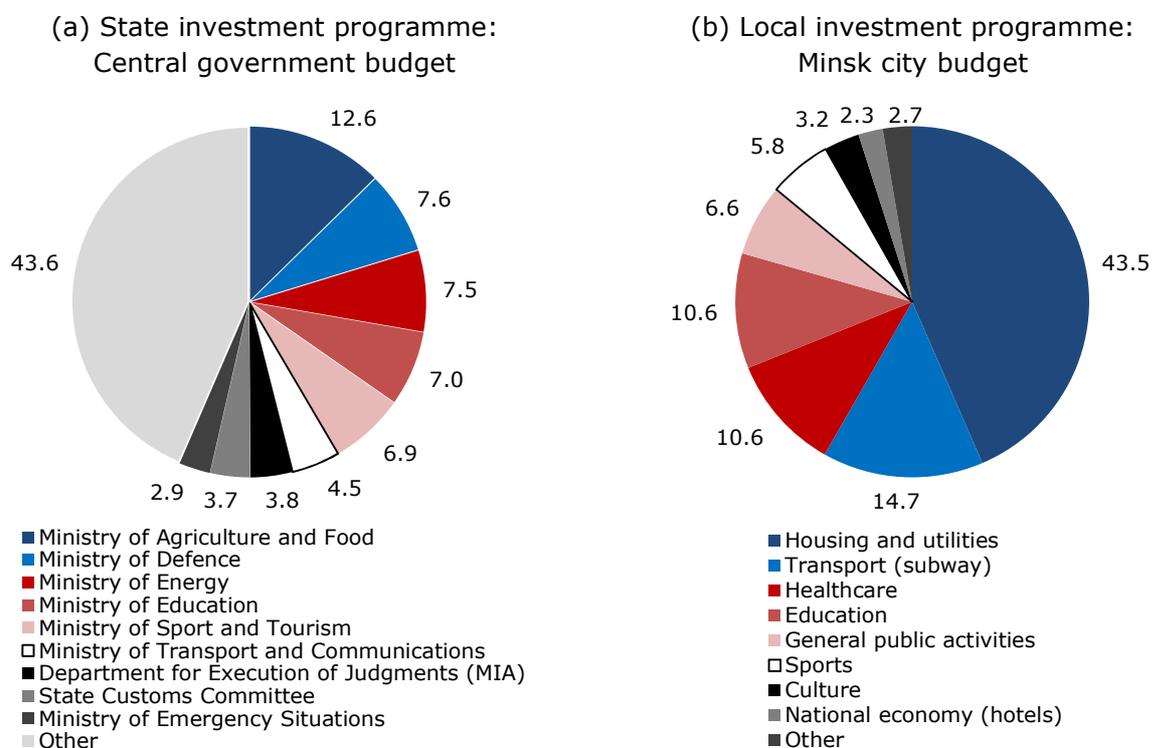
	<b>BYR bn</b>	<b>Beneficiaries or key projects</b>
1. Central government budget	5,681.1	
a. President fund	400.0	Ministries of Healthcare, Sports and Culture
b. National development fund	710.5	Ministry of Energy, Grodno oblast, etc. related to nuclear power station
c. Road construction	471.9	Ministry of Transport and Communications
d. Non specified	4,098.7	Diversified, see Figure Figure A.1a
2. Local government budgets	7,550.8	Social sphere and utilities, see Figure A.1b
3. Social security Fund	21.0	Administrative buildings of SSF
<b>Total</b>	<b>13,252.9</b>	

*Note. Line 'total' may include certain double counts, as there are transfers between the Social Security Fund and local government budgets.*

*Sources: Edict No. 70 from 20.02.2014 "On affirmation of state investment programme for 2014", and Ministry of Finance (2013) for local government budgets.*

**Figure A.1**

Planned structure of expenditures within state and local investment programme in 2014 (%)



Note. Expenditures from President Fund, National Development Fund and on road construction are not included.

Source: Edict No. 70 from 20.02.2014 "On affirmation of state investment programme for 2014"

Note. Expenditures planned to be financed by borrowings are not included.

Source: Decision of the Minsk city Council of Deputy on "Minsk investment programme for 2014"

### Innovation funds

Innovation funds are formed from profit earned by entities fully or partly controlled by local or central state bodies. The full list of organizations contributing to the funds is set by the Council of Ministers and is updated several times a year. The contribution is set at 10% of the profit taxes paid to the local or central budget.

The innovation funds have been set up to finance the development of high-tech industries and innovative projects that improve the competitiveness of the Belarusian economy<sup>13</sup>. The projects financed should meet certain criteria like a high level of value-added per employee, positive net exports, and the introduction of new technologies or products to Belarus. The funds provide financing both for implementing new technologies and for research aimed at the elaboration of these technologies. A constant share of the funds (5%) is spent on equipment and software for institutions of higher education. The repayment of the resources provided is implied only for projects financed from the Belarusian Innovative Fund. This institution operates only a small part

<sup>13</sup> Edict No. 357 from 07.08.2012 "Provisions on the principles of the innovation funds formation and their expenditures".

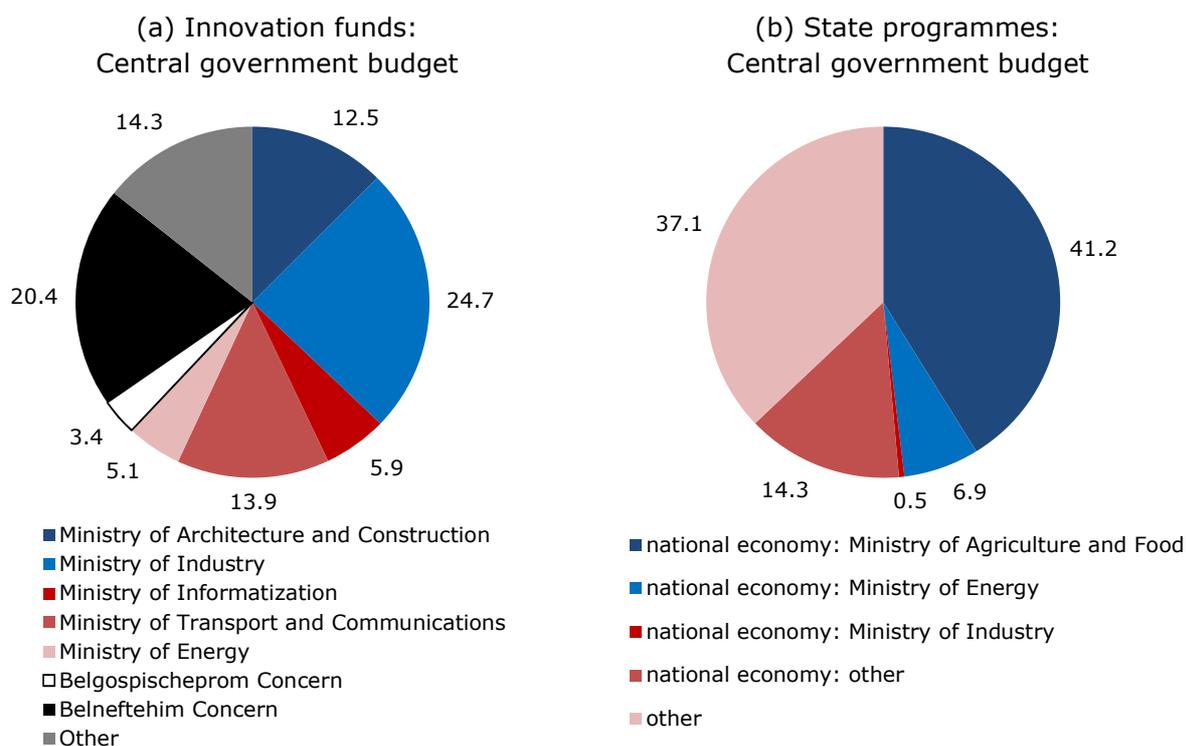
of the funds available (it accumulates 13.5% of all resources allocated for Republican innovative funds in 2014).

Financing is disbursed on a competitive basis to enterprises that contribute to the funds, and for research institutions of any ownership. If an enterprise applying has a mixed ownership, the financing provided does not lead to the increase of the state's share in ownership, which is the case with other types of state support. The effectiveness of the projects is assessed by the "State Committee for Science and Technology", based on the social-economic effects of the project, as reported by the applicant.

Revenues and expenditures of the Republican innovation funds (central government budget) are allocated between state bodies according to the decision of the Council of Ministers. In 2014, a large share of the funds is operated by the Ministry of Industry and the state holding Belneftehim (petrochemical industry). Other beneficiaries are the Ministry of Transport and Communications and the Ministry of Architecture and Construction (see Figure A.2a).

**Figure A.2**

Planned structure of expenditures within innovation funds and state programmes in 2014 (%)



Note. Based on volume of funds assigned between state bodies by Ministry of Councils.

Source: Resolution of the Council of Ministers No. 182 from 28.02. 2014 "On allocation of revenues and expenditures of the republican innovation funds according to resource administrators of the republican innovation funds"

Note. Expenditures by Ministry of Agriculture and Food include transfers to local budgets within programmes for sustainable development of rural areas and for equipping agricultural enterprises.

Source: Estimates based on the "Law of the Republic of Belarus No. 95-3 from 31.12.2013 "On the Republican budget for 2014"

### Other state programmes

A state programme is defined as a programme, approved by the President or the Council of Ministers, financed in full or partly by the central government budget, or extra-budgetary state funds<sup>14</sup>. The goal of a programme should correspond to the key directions of the current Socio-Economic Development Programme (set for five years). Possible sources of financing for the state programmes are central and local government budgets, extra-budgetary funds, own funds of the organizations involved, and credit sources. Banks that are to finance state programmes are chosen on a competitive basis.

Expenses within state programmes are classified into three groups: scientific support, investment projects, and others. Investment projects, which are planned to be financed from central or local budgets, should be registered in the state or regional investment programmes respectively and financed from related sources. The central government budget provides data on the expenditures within state programmes financed outside the state investment programme. In contrast to the state investment programmes, a significant share of these expenditures is focused on the national economy. In 2014, the central budget is expected to finance 78 programmes, 43 of which are related to national economy issues<sup>15</sup>. The expenditures on these programmes constitute 62.9% of total central budget expenditures on state programmes (excluding state investment programmes and innovation funds). Most of these economy-related programmes are focused on agricultural issues (21 programmes form 65.5% of expenditures on economy-related programmes) and energy issues (10 programmes, 11%). The Ministry of Industry benefits from only six programmes (0.8% of expenditures on economy-related programmes).

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<sup>14</sup> Decision of the Council of Ministers No. 404 from 31.03.2009 "Provisions on the principles of the state, regional and sectoral programmes formation, financing and control of their fulfillment".

<sup>15</sup> Includes a programme for equipping agricultural enterprises. It is financed by local government budgets that are supported by transfers from the central government budget.