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Recommendations for reforming the SME Definition in Belarus

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Recommendations for reforming the SME Definition in Belarus

Executive Summary

The classification of small and medium-sized enterprises (SME) in Belarus is inappropriate. Consequently, the official statistical research and publications do not provide reliable data for policy makers, which hinders the development of efficient SME policy.

We therefore recommend reforming the legislation that stipulates the SME definition.

A new appropriate SME definition for Belarus should be able to distinguish real SME - economically and legally autonomous business entities - from small and medium-sized legal entities that belong to the state, holdings, concerns, affiliated companies and similar structures.

Both the SME definition of the Russian Federation and the EU SME definition could act as role models for Belarus.

We recommend adopting the EU SME definition in Belarus, because adopting the EU SME definition will bring several advantages and does not encounter significant disadvantages. When adopting the EU definition, Belarus moves even closer to the Russian SME classification.

Most importantly, companies that belong to the state (state owns 25% or more of the shares) or which are controlled by the state should not be regarded as an SME. That is in line with international best practice.

We recommend a step-by-step reform of the SME definition and of the harmonization of SME related norms in Belarus. In that way, changing the SME definition will have little impact on other regulation in the first step.

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1 Introduction

The Ministry of Economy of the Republic of Belarus has decided to revise and change the current legislation that defines and classifies small and medium-sized enterprises in Belarus.

This paper aims at supporting that reform process with providing analytical information. The paper succeeds the Policy Briefing PB 09/2016 „Proposals for reforming the SME definition in Belarus“, which stressed already the need for a reform of the SME definition and provided some recommendations. As a result of the economic dialogue, the Ministry of Economy asked for further information in order to facilitate the policy formation process and to put the Ministry in the position to decide on a new definition and its parameters.

The paper is structured as follows: the following chapters 2 to 5 deal with specific questions raised during the dialogue. Chapter 6 concludes with a proposal for a step-by-step reform implementation process.

2 The major problems with the current SME definition and the major requirements for a reform

The current SME definition, as stipulated in the Law of the Republic of Belarus 1 July 2010 No. 148-V (as amended as of 30 December 2015) on “State support for small and medium-sized enterprises” applies the only criterion *average annual staff headcount* for classifying companies. Every company that employs less than 251 people is regarded as an SME.

According to the law several enterprise categories exist:

1. Individual enterprises (entrepreneurs)
2. Micro enterprises
3. Small enterprises
4. Medium enterprises
5. Big enterprises.

The headcount for an individual entrepreneur is 1, for micro enterprises the headcount ranges from 1 to 15, for small enterprises from 16 to 100, medium enterprises from 101 till 250 and every company with more than 250 employees is considered as a big enterprise.

Such simplicity of classifying SME has several drawbacks.

First of all, the definition does not take into account company groups, multi-corporate enterprises, holding company structures or affiliated companies. This is in contrast to international practice. Usually, if a company is split into several legal entities, which are economically dependent, those entities are regarded as belonging to one unit. It is world-wide uncommon to regard subsidiaries and holding entities as separate business entities. In Belarus, in contrast, it is common.

As an example: Belarussian big state-owned enterprises (SOE) often have a company structure that is similar to the Western model of a *management holding*. In particular, many big industrial SOE have a separate sub-unit so-called *trading house*, which is a separate legal entity and which is responsible for all sales of the company group. The point is, that such *trading houses* often employ few employees. According to the Belarussian SME definition, there are - in that cases - regarded as SME, although they belong to big industrial concerns. The Belarussian Potash Company JSC, for instance, is

the *trading house* of one the biggest Belarussian industrial SOE. It employs less than 100 people¹ and is therefore regarded as a small enterprise according to Belarussian legislation. The Belarussian Potash Company JSC reports huge sales (EUR 1.7 bln turnover in 2015) which are in fact the sales of the Belarussian Potash enterprise group. However, the Belarussian SME statistics regards the sales of the potash *trading house* as SME sales. Since the practice applies to many SOE with *trading houses*, the official Belarussian SME statistics overstates the sales generated by the SME sector and thus overstates the share of GDP generated by the SME sector.

Furthermore, since many industrial SOE with *trading houses* are exporters (oil traders etc.), the official Belarussian SME statistics overstates the export share of the SME sector.

Conclusion 1: The Belarussian official statistics do not provide a clear picture of the SME sector with respect to the number of SME, the sales, the share of GDP and the share of export.

The second problem, which is a consequence of the first problem, is that it is very difficult to benchmark the development of the SME sector in Belarus with the development of the SME sectors in other countries (neighbor countries, peer countries...).

The third problem: An appropriate SME policy formulation is very difficult, when the information about the SME sector is deficient. The same is to say for policy impact assessment and SME policy evaluation.

Conclusion 2: The current Belarussian SME definition hinders the development of an efficient SME policy.

Further problems arise from the fact, that there is a variety of Belarussian legislation stipulating additional and non-uniform criteria for defining small and/or medium-sized companies (see also chapter 4). This is confusing for beneficiaries as well as for international donors.

A specific challenge in Belarus is the state influence in different spheres – many SME are either directly owned or controlled by the state and its bodies.

Conclusion 3: A new appropriate SME definition for Belarus must be able to distinguish real SME - economically and legally autonomous business entities - from small and medium-sized legal entities that belong to the state, holdings, concerns and affiliated companies and similar structures.

Both the SME definition of the Russian Federation and the EU SME definition can act as role models for Belarus, because both definitions identify independent and autonomous business entities.

¹ Average number of employees as for the second quarter of 2016 was 94 (<http://emitent.info/issuers/3355>).

3 Adopting the Russian SME definition vs. adopting the EU SME definition

In the Russian legislation, SME are defined as non-subsidary, independent firms, which employ less than 250 employees and have an annual turnover of less than 2,000 m Rubles.

The Russian definition is generally in line with international practice. The methodology with respect to specifying the variables “non-subsidary” and “independent” resemble the methodology of the EU practice. The specific threshold criteria for distinguishing big companies from small and medium-sized companies make all the difference.

In detail, the Russian SME definition is as follows:

Article 4 of the Federal Law as of 24.07.2007 number 209-FZ "On the development of small and medium-sized enterprises in the Russian Federation" stipulates:

Small and medium-sized enterprises must meet three criteria:

Criterion 1. Ownership structure

Stakes held by one or several legal entities, which are not small or medium-sized businesses, should not exceed 25% of the SME's capital respectively acting voting rights.

More precisely:

1) The total share of the Russian Federation, the Russian Federation municipalities, public and religious organizations (associations), charitable and other funds do not exceed 25% of the authorized (share) capital (mutual fund) of legal entities.

Exceptions are assets of joint-stock investment funds, closed-end mutual funds and investment partnerships. (There are some more regulations dealing with side issues such as the stakes of research institutions, budgetary institutions, institutions of higher education etc.)

Criterion 2 Average number of employees

The average number of employees during the preceding calendar shall not exceed:

- a) 14 for micro-enterprises;
- b) 100 for small businesses,
- a) 250 for medium-sized enterprises;

The average number of employees of micro, small or medium-sized enterprises in a calendar year is determined by taking into account all its employees, including employees working under civil contracts or in combination based on actual hours worked, employees of representative offices, branches and other separate subdivisions.

Criterion 3: Revenues from the sale of goods and services

Revenues from the sale of goods and services, excluding VAT, for the previous calendar year shall not exceed:

- 120 m Rubles for micro enterprises;
- 800 m Rubles for small enterprises;
- 2,000 m Rubles for medium-sized enterprises;

These values get reviewed by the Government on a regular basis (the above mentioned values are determined by the decree of the Government of Russian Federation as of 13.07.15 N 702 "On the limit values for the sales of goods and services for each category of small and medium-sized business").

The category of small or medium-sized enterprises is determined in accordance with the highest value on the conditions set by the criteria 2 and 3.

Example 1: An individual entrepreneur or legal entity has an average number of 15 employees, and the revenues from sales equal to 900 million rubles. The entrepreneur (company) is classified a "medium-sized enterprise."

Example 2: The revenues from the sale or the value of the assets is less than 120 million rubles, and the average number of employees is over 250 people, the is regarded as a large enterprise.

The classification of an SME changes only if the values specified in the criteria 2 and 3 change during two consecutive calendar years.

We have described the SME definition of the EU in detail in our preceding publication PB/09/2016. To sum up, the EU definition firstly uses different classification threshold values regarding the number of employees and revenues as opposed to the Russian definition; and it secondly has an additional classification criterion (asset sheet total). In practice, the classification according to the EU definition will not differ tremendously from the classification applying the Russian definition.

The main advantages of adopting the EU SME definition would be as follows.

- A) Benchmarking the Belarussian SME sector development with the SME sector development of European countries would be much easier than nowadays. This is true for benchmarking with EU member states as well as for benchmarking with Ukraine and with Georgia, since the latter two countries have reformed their SME definition according to EU practice. As a positive side-effect, benchmarking the Belarussian SME sector development with the Russian SME sector development would become easier as well, because the EU definition resembles the Russian definition much more than the current Belarussian definition does.
- B) Belarussian entrepreneurs and companies already have access to a number of European SME promotion programs and funds. In order to apply for such support, the companies must comply with the EU SME definition. Adopting the EU SME definition in the legislation, therefore, improves the access of Belarussian entrepreneurs and companies to European funds.

Box 1

Examples for European SME support programs for Belarussian entrepreneurs and companies

- Eastern Partnership SME Finance Facility
- Women in Business to promote female entrepreneurship
- Small Business Initiative in order to direct finance towards SMEs

Source: <http://www.eu4business.eu/belarus/presence> [last access as of 24 may 2017]

The main advantages of adopting the Russian SME definition would be as follows.

- A) On first sight, the Russian SME definition seems to be less complex than the EU SME definition, because it uses only two classification values – number of employees and yearly turnover – whereas the EU definition takes into account the asset sheet totals of the companies as well. In practice, dealing with three classification values is not a problem from the point of view of methodology. In other words, processing statistical data in order to classify companies is not going to be easier with the Russian SME definition than it is with the EU definition. This is because, the main challenges with respect to the methodology are made by the criterion defining “non-subsidiary” and “independent”, and this criterion has the same degree of complexity in both the Russian and the EU SME definition.
- B) Benchmarking the Belarussian SME sector development with the Russian SME sector development is much easier, if both countries apply the same classification method. This argument gets even more convincing if there are plans to harmonize or unify the SME definition within the Eurasian Economic Union (EAEU), because it would enable the comparison of the developments of the SME sectors of all EAEU member states. The question is: are there any plans to unify the SME definitions within the EAEU?

Beyond those two arguments, of which one argument is rather weak, one cannot see any further advantages of the Russian SME definition over the EU definition. Apparently, there are no plans for SME development programs or funds within the EAEU, and the Russian SME programs are exclusively for Russian companies and Russian entrepreneurs.

Conclusion 4: Adopting the EU SME definition will bring several advantages and does not encounter significant disadvantages as opposed to adopting the Russian SME definition. When adopting the EU definition, Belarus moves closer to Russian practice than it is today.

The implementation of either of the two definitions in Belarus is faced with a major challenge: there are no tools or data in Belarus to unveil company structures and identify “non-subsidiary” and “independent” enterprises. Whilst in most industrial countries the financial reports show company structures and ownership structures, companies in Belarus are not required to report consolidated accounts. There is no company register with complete ownership information, neither.

In order to deal with that shortage, the new SME definition should at least implement turnover criteria and assets sheet related criteria. In that way, artefacts and illogical results such as caused by *trading houses* can at least be reduced.

However, the measuring of asset sheet totals is also very difficult in Belarus, because of peculiarities of the system inherited by the Soviet Union. Companies often possess no assets, because assets often belong either to the state or to other companies. It is difficult to match assets and producers.

Conclusion 5: The second best approach for a new appropriate SME definition for Belarus is to implement turnover criteria.

As we said already, a specific challenge in Belarus is the state influence in different spheres – many SME is either directly owned or controlled by the state and its bodies.

Both the Russian and the EU SME legislation take only those companies into account, which have less than 25% shares owned by the state.

Unveiling enterprises' ownership structure is very difficult in Belarus, but it is possible for the state-owned enterprises.

We, therefore, recommend excluding all companies, that are owned or controlled by the state, from the SME status. In particular, according to international practice, a company shall only be classified as an SME if it has less than 25% of its shares/stakes owned by the state.

Conclusion 6: Companies that belong to the state (state owns 25% or more of the shares) or which are controlled by the state should not be regarded as an SME, because they are no “

4 Impact of reforming the SME definition on other regulation

Being considered as an SME allows benefiting from several advantages like lower tax rates, state subsidies and others.

However, there are several additional criteria established in other legal provisions (see below) narrowing the scope of application of such benefits.

A review of the Belarusian legislation shows that the understanding of “small and medium-sized enterprises” is not very widely spread – one will find it only in a few provisions. These are - besides the law on “State support” (see above) – the following:

4.1 Tax regulation

Article 286 Tax Code 29 December 2009 Nr.71-3 as amended on 09 January 2017 allows to opt for the so called simplified taxation regime if the headcount does not exceed 100 person (or for individual entrepreneurs) and the revenues in the first nine months of the previous year do not exceed BYN 1.159.800 or BYN 126.700 for individual entrepreneurs respectively. The Tax Code does not refer to the SME definition but establishes its own classification thresholds. In the same way, the entitlement for the simplified VAT system is defined by specific criteria in the Tax Code, independently from the SME definition as stipulated in Law No. 148-V (see above).

Conclusion 7: Changing the SME definition will have no impact on the Simplified Taxation Scheme in the first step.

4.2 Labor law

Individual entrepreneurs and micro enterprises benefit from an exception in the labor code. Usually, the conclusion of a fixed-term employment contract requires a justification, but individual entrepreneurs and micro enterprises are free to conclude such fixed-term employment contracts without any limitations (Article 17 Labor Code 26 July 1999 Nr.296-Z as amended as of 15 July 2015).

Conclusion 8: Adopting the Russian SME definition will have no impact on the Labor Law privileges. Adopting the EU SME definition means that fewer companies are entitled for using fixed-term employment contracts, because the EU definition of micro-enterprises is more strict than the current Belarussian definition.

4.3 *Public procurement*

In a public procurement procedure and in case an object to be procured (goods and/or services) can be divided, ten percent of the volume is exclusively reserved for small and medium-sized enterprises if they offer goods and services from their own production according to the respective legal provisions (Article 31 Law on Public Procurement 13 July 2012 No. 419-Z). The Law on Public Procurement presumes the definition of small and medium enterprises according to the law No. 148-Z but adds the condition, that goods/service must origin from the enterprises' own production.

Conclusion 9: Adopting either the Russian SME definition or the EU SME definition might have an impact on the entitlement for privileged access to public procurement, because both definitions are stricter than the current Belarussian definition. Especially state-owned SME will be treated like regular enterprises.

4.4 *State promotion of innovation*

Article 36 of the Law of the Republic of Belarus on innovation policy and innovation activity in the Republic of Belarus 10 July 2012 No. 425-Z stipulates that state funds for innovation projects must dedicate at least ten percent of the funds to small and medium-sized enterprises.

Conclusion 10: Adopting either the Russian SME definition or the EU SME definition might have an impact on the entitlement for privileged access to the state innovation funds, because both definitions are stricter than the current Belarussian definition. Especially state-owned SME will be treated like regular enterprises and therefore excluded from privileged access.

4.5 *Further impact*

All state funded development programs, e.g. special financial support programs, use different entitlement criteria.

The presidential decree as of 21 May 2009 No. 255 „On state activities for the development of small enterprises” addresses small enterprises and infrastructure for the support of small and medium-sized enterprises (“business incubators”). The decree provides for government funding but again: not only the headcount but also the revenue is relevant. The revenue thresholds are established every year anew by the Council of Ministers. The thresholds for the year 2016 (to apply for funding in 2017) are as follows: for individual enterprises 335.400 BYN, for micro enterprises 2.459.600 BYN and for small enterprises 9.279.400 BYN.

It is not possible to apply for governmental funding if the revenues or the headcount exceed the thresholds, if the state or a foreigner owns more than 49% of the shares of the enterprise or belongs to a fund or other entity not being a small or medium-sized enterprise. It is also not possible to obtain funding for a banking company, an enterprise that concluded a concession agreement with a foreign investor or is being involved in betting or lottery business.

Once granted, governmental funding will be distributed either through the funds for financial support of entrepreneurs or state entities (loans, subsidies, building lease, guarantees for preferential loans provided by Belarusian banks, refund of expenses for trade fairs).

Sources of financing of state support for SMEs are defined in the State program «Small and medium entrepreneurship in the Republic of Belarus» for 2016-2020 and include financial resources of republican and local budgets, fund for financial support of entrepreneurs as well as Development Bank of the Republic of Belarus. While Development Bank's financing is provided at his own expense through bank-partners and under more strict criteria for SME recipients compared to those defined in decree #255: the share of the state should be less than 25%, total share of non-residents should be less than 49%, the annual revenue should be less than 25.000.000 BYN (the headcount criteria is the same).

Conclusion 11: Neither adopting the Russian SME definition nor adopting the EU SME definition will have a direct immediate impact on current SME support programs.

5 SME status verification

As described above, smaller businesses may enjoy some privileges with respect to taxation, access to state promotion programs etc.

In order to verify whether or not an entrepreneur or company is entitled to receive support, privileged access or privileged treatment, officials need to check certain documents.

According to the proposed road map (see chapter 5), the first step of reform would be a change of the SME definition in the Law No. 148-V with immediate effects on the statistics. None of the authorities, state agencies, institutions of business support infrastructure etc. will need to change any of their procedures and practices with respect to the existing verification procedures, at least in the first step.

Assuming the long-term goal is to harmonize or even unify all SME definitions across all legal norms, it could be wise to harmonize the practices for verifying the SME status, too. In order to do so, Belarus can profit from international experience regarding standardising and harmonizing verification procedures.

The following highlights different practices from international experience and ends with a conclusion for Belarus.

5.1 *The lately modernized Russian practice*

The Federal Tax Service (FTS) of Russia together with the Ministry of Economic Development of Russia and the JSC "Federal Corporation for Development of Small and Medium-sized Enterprises" have started to create the single "Unified Register of small and medium-sized enterprises". It is a database containing information on Russia's SMEs. The register's information can be used to confirm that a certain business entity belongs to the category of SME.²

The register's data entries are created automatically on the basis of the FTS database, without introducing new administrative procedures or requiring any additional documents.

The following information is used for the creation of the register:

² https://www.nalog.ru/rn77/related_activities/regbusiness/#t1

- information from the tax reporting (documents relating to the application of special tax regimes) for the previous calendar year, provided by the FTS,
- information from the Single State Register of Legal Entities and the Single State Register of Individual Entrepreneurs.

To check whether the information about the legal entity or individual entrepreneur is in the Unified Register of Small and Medium-sized Businesses, it is necessary to visit the official FTS website and use a special free service, which has been available since 1 August 2016.

Thus from 1 August 2016 on, SME do not need to submit documents proving their status as SME, when they apply for state support programs.

The basic approach of the formation and maintenance of the register is an auto-assignment principle of the status of SMEs on basis of existing FTS information, without the introduction of administrative procedures or collecting additional documents.

The information on whether a business entity falls into the category of SME, is updated annually on August 10 of the relevant calendar year based on the data that will be at the disposal of the Federal Tax Service of July 1.

SME are held liable of submitting false information in cases that such information will be used by entities that refer to the registry information.

5.2 *The German approach*

In Germany, the verification of the SME status, and thus the verification of the entitlement to SME related funds, programs and privileges, is mainly based on self-declarations. The entrepreneur or company simply states whether he/she/it complies with the EU SME definition.³ The entrepreneur or company manager shall use the SME definition guideline, as provided by European authorities for free, to assess the entrepreneur's or company's status. The entrepreneur/company manager is accountable for that declaration. In case he/she lies and it is discovered, such a false declaration is regarded as a crime and persecuted accordingly.

Therefore, only in cases when the authorities have doubt about the correctness of the self-declaration, the authorities ask for more documents or start investigations.

It is worth noticing that most SME support programs in Germany are targeted to specific industries, specific company characteristics etc. Therefore, beneficiaries often need to meet much more requirements than just the SME status. Applications for state programs and implementations of the programs require often much resources. This is because policy makers aim at diminishing the opportunities for lorry effects on subsidies. In other words, companies have almost no incentives to deceive with false self-declarations about the SME status.

5.3 *Selected European practices*

- The European Medicines Agency requires a self-declaration as well as supporting documents when applying for its SME programs. The supporting documents include: the most recent annual accounts, the proof of the establishment of the company in the

³ Example for a self-declaration:

http://ec.europa.eu/environment/eco-innovation/files/docs/contract/sme_declaration.doc

EU/EEA, a chart of the ownership structure of the applicant.⁴

- The European Chemical Agency sets even higher verification requirements for applying for its SME reduced fee:⁵
 - Documentary evidence* showing the ownership structure at the date of the submission: Commercial registry extract, Articles of association, Incorporation documents, Memorandum of association, company's shareholders book, etc.
 - Copies of the official audited financial accounts along with the accompanying notes and annual reports for the two latest approved fiscal accounting periods, preceding the time of each submission as well as those of any partner and/or linked enterprises.
 - An official certificate/information from an official authority confirming the headcount of staff that corresponds to the number of annual work units (AWU), in accordance with Article 5 of the Annex to the Commission Recommendation, for each of the two latest approved accounting periods, preceding the time of each submission.
- The EU SME program framework *Horizon 2020* pursues a different approach. It uses a beneficiary register.

Conclusion 12: Since the SME support programs in Belarus are currently very limited in scope and scale, we do not see the need for complex verification procedures. In the long-term the Russian approach or a similar beneficiary register might be of interest for Belarus.

4

http://www.ema.europa.eu/ema/index.jsp?curl=pages/regulation/general/general_content_000061.jsp&mid=WC0b01ac0580024b96

⁵ <https://echa.europa.eu/support/small-and-medium-sized-enterprises-smes/sme-verification>

6 Proposal for an implementation roadmap

The following briefly sketches a roadmap of a step-by-step reform of the SME definition.

6.1 *Changing the definition and updating SME statistics*

As described above, a change of the SME definition in Law No. 148-V will have no direct significant impact on other legislation and will therefore come with no significant costs.

The immediate effect of the first reform step will be a change in the SME related statistics and publications of the National Statistical Committee. This will be an improvement in any case, no matter if adopting the Russian or the EU definition, since the modernized statistics will provide a better view on the SME sector's state of facts and development and will facilitate the comparison with the SME sectors of other countries.

6.2 *Harmonizing the methodology of legislation concerning SME*

As described above, several laws and legal documents deal with smaller businesses. It is not necessary to apply the same definition of SME in all those laws and legal documents on the very first step. However, it would be recommendable to reflect similarities and differences between the SME definitions in the legal methodology. We recommend doing so using referrals between legal norms. We recommend having one central SME definition stipulated by one central legal norm; all other legal norms should refer to that central definition and stipulate additional requirements, criteria etc. if appropriate.

Example: A certain document addresses "... SME as defined in Law No. 148-V and additionally complying with the following requirements ...".

6.3 *Unifying the SME definition*

As described above, several laws and legal documents deal with smaller businesses. In the long-term, it is recommendable to apply the same definition of SME in all those laws and legal documents. As an example, the presidential decree as of 21 May 2009 No. 255 „On state activities for the development of small enterprises” is updated regularly with respect to the revenue criteria defining entitled beneficiaries. These updates should step by step approach the same revenue criteria as in the then reformed Law No. 148-V. Such a harmonization of the SME definition across all legal norms will come with some costs. However, when harmonizing slowly step-by-step, the costs will be spread over time and will not cause significant distortions.

Conclusion 13: We recommend a step-by-step harmonization of SME related norms. The modernization of the SME statistics in Belarus is the most urgent positive effect of the reform.

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