Lessons

The World Bank FPD Note No. 21 September 1994

Private Sector Development in Belarus

Itzhak Goldberg and David Phillips

Belarus has moved very slowly to dismantle its state enterprises and associated trading monopolies. This in part accounts for the fact that in 1994 private nonagricultural enterprises accounted for less than 10 percent of employment. Nevertheless, a private sector clearly is emerging. A recent World Bank survey shows that so far it has developed through three basic channels: (1) "start-ups," including new entrepreneurs who founded enterprises with a "greenfield" investment; (2) 100 percent "buyouts"—privatization of state-owned enterprises (SOEs), usually through a buyout by employees; and (3) "spin-offs," business entities that develop as spin-offs of SOEs by leasing capital assets from the SOEs or through employee buyouts of parts of SOEs.

Like many countries of the former Soviet Union, Belarus requires a comprehensive strategy to create a more conducive environment for private sector activity. This Note explains the approach the Bank used for designing such a strategy in Belarus (see box on page 2), and it identifies the three critical constraints to enterprise development that emerged from this work.

Key constraints

The World Bank survey revealed the following characteristics of the start-up, buyout, and spin-off enterprises. The start-up enterprises have dynamic management but lack capital and access to business premises. They began with very little of their own funds, and most of them had to generate their capital mainly through trade or services. The buyouts have an existing business site and equipment but have not changed their management style. The spin-off enterprises combine the advantages of both—they frequently have dynamic management and are able to get space and equipment from the "parent" state-owned enterprises.

Overall, the survey indicated three major constraints to enterprise development: rudimentary business strategies, ill-defined property rights, and limited availability of investment credit in the high-inflation environment.

Business strategies

Most of the managers and owners of the private sector firms are university-educated—with backgrounds in engineering, computers, or science. They consist of three groups: production engineers from the SOEs, who bring to
Survey structure and results

Life cycle approach
A systematic review of pressures and incentives shaping business behavior should be structured to address the three stages in the life cycle of a firm: (1) entry—start-up or privatization; (2) operation and growth; (3) exit—closure and bankruptcy, but also partial exit, and downsizing of labor force and asset transfer (sale or lease) to other firms. Exit conditions are also important for entry and growth because lenders will look to the efficiency of closure regulations as security for asset-based lending. Flexibility in downsizing and labor mobility and asset transfer are important for restructuring and therefore may encourage outsiders to get involved in privatization-entry.

Structured this way, the survey of existing firms in Belarus allowed the Bank to study the entrepreneurs' perception of the relative importance of the different constraints. However, a difficulty with this approach is that it excludes entrepreneurs who failed to start up. The survey method does not give a complete reading on entry constraints. Therefore, to prevent survey bias, entry constraints had to be studied separate from the survey—through discussions with lawyers, business facilitators, and so on.

Some summary findings
- 18 percent of the firms surveyed were located in Gomel, 17 percent in Brest, 16 percent in Minsk;
- nearly 50 percent of the firms were involved in trade, 26 percent were in manufacturing, and 16 percent were in services;
- the average age of the firms was 18 months;
- the average number of employees was 42;
- 25 percent of firms reported that they faced no competition in product markets, 40 percent said they compete with private firms, and the rest said they compete with SOEs;
- 70-80 percent reported that almost all transactions were done on a prepayment basis.

The survey was conducted in November 1993. Because of the survey limitations (see above), the results were supplemented with findings from discussions with the government and private business.

Constraints
Companies were asked to rank constraints, which were then listed on a scale of 1 to 5 (figure 1). The most serious operational constraints were lack of available credit, high taxation, and inadequate or inappropriate equipment and working space. Macroeconomic problems (especially inflation) were a general concern. Existing companies also listed difficulty with dismissing workers as one of their top constraints, indicating a need and desire to “downsize” without the ability to do so. Of the top ten constraints, three are entry constraints, six are operational and growth constraints, and one is an exit constraint.

Proposed program
The private sector development program the World Bank proposed for Belarus includes:
- action to facilitate entry: abolition of licensing, promotion of state enterprise asset sales, and the development of real and movable property titling and registration for collateral purposes;
- action to facilitate operations and growth: reform of taxation (especially the value-added tax), reform of enterprise accounts to conform with generally accepted accounting practices, and measures to promote exports, including amendments to the foreign exchange regime;
- actions to facilitate exit: arrangements for state enterprise closure and liquidation, with or without bankruptcy action (to release state assets to the private sector).

Figure 1 Sources of business constraints, as ranked by enterprises
(5 = severe constraint, 1 = minor constraint)

<table>
<thead>
<tr>
<th>Constraints</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>5</td>
</tr>
<tr>
<td>Access to credit and banking</td>
<td>5</td>
</tr>
<tr>
<td>High taxes</td>
<td>5</td>
</tr>
<tr>
<td>Energy supply</td>
<td>5</td>
</tr>
<tr>
<td>Difficulty dismissing workers</td>
<td>4</td>
</tr>
<tr>
<td>Access to transport</td>
<td>4</td>
</tr>
<tr>
<td>Skilled labor supply</td>
<td>4</td>
</tr>
<tr>
<td>Laws/frequent tax changes</td>
<td>4</td>
</tr>
<tr>
<td>Finding affordable space</td>
<td>3</td>
</tr>
<tr>
<td>Raw material supply</td>
<td>3</td>
</tr>
</tbody>
</table>

Note: Enterprises also named as constraints lack of legal ownership rights, access to markets/low demand, underdeveloped infrastructure, problems with registration committees, and obtaining licenses; each of these was ranked at less than 2.33 on the scale.
the business assets, experience in production, and their networks of old contacts; academics and scientists who are former employees of state academic and research organizations and who have problems in knowing how to commercialize their specialized knowledge and innovative ideas; and young, often recent graduates, who are more dynamic (not of the old management style) but have very little production experience.

Discussions with individual entrepreneurs revealed three main weaknesses in their strategies. First, a lack of “core business competency” is reflected in an extreme diversification into unrelated products. Many companies plan investment in products unrelated to their current production and in industries unrelated to each other. This approach to business is inconsistent with Western practices and may deter investors because the new entrepreneur cannot provide “credentials” or a record of prior success in related activities. There are several possible reasons for this extreme diversification:

• entrepreneurs choose their field of investments according to their connections, and partnerships have arisen in two or three fields that are in effect the former occupations of the partners in the state sector;
• uncertainty in Belarus’s economy causes a need for diversification to minimize risk;
• lack of experience results in choosing investments by “trial and error”—that is, entrepreneurs begin many activities aware that eventually only one or two will be sustainable;
• different activities are used to raise initial capital for a later use in the core activity.

Second, lack of market and competitor information is a major obstacle to a strategic business approach; and ad hoc decisions dominate business development.

Third, inflation is a major source of confusion in business planning. There are two difficulties: the financial accounts are so distorted by inflation that entrepreneurs do not know for sure whether they made a real profit last year or a fictitious nominal profit, and inflation, which is both nonuniform and unpredictable, makes projections difficult, even in foreign currency.

A private sector development program should address these issues by making business consultancy services an essential part of any investment financing. The World Bank’s recommended program for Belarus supports a network of “independent business centers” that would assist entrepreneurs in, among other things, acquiring information on markets and competitors, defining business strategies, and establishing management and financial planning systems (for example, inflation-adjusted cost accounting, which would allow firms to improve evaluation methods compared with the current ad hoc “payback” approaches).

However, more important than the business consultancy services is the pressure of lenders and investors requiring entrepreneurs to submit business plans, feasibility studies, and financial reports. Although in theory entrepreneurs should plan for their own sake, in practice the pressure from outside investors is crucial. It is even more critical in an environment in which there are no outside directors on the companies’ boards of directors who would demand executive management accountability.

**Asset transfer and property rights**

Private enterprises have considerable difficulty acquiring appropriate production and office space. Consequently, many enterprises face delays in starting business, or they operate in makeshift facilities that are not conducive to the efficient operation of the business. The problems of getting space arise because of the lack of incentives for managers of SOEs, institutes, and ministries to shed excess space; confusion over who has the authority to lease space; and lack of transparency in the process for locating and leasing space.

What is needed is a public inventory of unused space and guidelines for setting the criteria and process by which private enterprises will be permitted to rent or lease office space or physical plant owned by the republic, oblasts, municipalities, and state-owned enterprises.

The right to sell and lease SOE assets (equipment and space) needs to be clarified and the process de-
centralized. Similarly, the ownership of assets transferred to spin-off enterprises should be clearly established. Once ownership is apparent, an incentive system should be instituted that is transparent and that facilitates the rapid resale of space and underutilized equipment. Managers of SOEs should be motivated to lease (or sell) excess space or equipment. Privatization and tighter budget constraints will exert pressure to do so. Since many managers still hope to use the idle capital “when the situation improves,” more realistic expectations motivated by a harder budget constraint may speed up the asset transfer process.

**Investment credit in a high-inflation environment**

The survey findings show that entrepreneurs plan investments whose average size is US$200,000, about half of which is for imported equipment. Only half of the entrepreneurs surveyed had been able to access bank credit. Those who did got local currency credit for one to three months—and a few for up to twelve months. The interest rate on this short-term credit is set by the central bank, and at the time of the survey (November 1993) it was 130 percent a year. The effective compound interest rate on rolled-over credit combined with front-end fees and compensatory balances was considerably higher but still represented a negative real interest rate since inflation was over 1,000 percent.

Insofar as an element of subsidy existed for ruble credit, it was puzzling to find that survey respondents wanted dollar credit and were willing to pay an interest rate of up to 15 percent (a positive real rate) on a dollar loan. This apparent contradiction (which was also noted in a St. Petersburg services survey) can be explained as follows: The subsidized ruble loans are rationed and limited to well-connected enterprises, frequently bank shareholders (especially SOEs), and the ruble loans are all short-term (one to three months) and therefore inappropriate for investment financing. The foreign currency loans are perceived as long-term investment financing. Entrepreneurs said that repayment of loans in foreign currency was not going to present problems: a third were dealing with foreign currency in their operations, and another third stated that they could buy it on the foreign currency exchange. Moreover, some enterprises use foreign currency as the unit of measurement in setting prices and calculating costs and therefore believe that they can manage the foreign currency risk.

**Incentives for change**

The private sector survey showed that while a large body of market-oriented legislation relating to companies and the capital market has been enacted, it is often inconsistent and difficult to enforce in an environment in which basic ideas about contracts, property, and legal title have been in abeyance for three generations. Thus, the problem is not only about legal infrastructure and institutions, but how to make them work effectively. For example, to facilitate the release of redundant assets from SOEs to private companies, it is not enough to set the rules for lease or sale. Only when the hard budget constraint starts to bite will firms be forced to act—to raise income from the sale or lease of surplus assets. Therefore, faster privatization and the tightening of subsidized credits to enterprises need to be implemented together with regulatory reform and the business centers.

The authors would like to acknowledge the help of Nena Manley and David Kochav in the Belarus private sector development study.

---

Itzhak Goldberg, Senior Regional Economist, Europe Department, International Finance Corporation, and David Phillips, Senior Enterprise Reform Specialist, Europe and Central Asia Department 4