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Discussion Papers

# 30 YEARS OF ECONOMIC TRANSFORMATION IN CEE: KEY FIVE LESSONS FOR BELARUS

Written by Sierž Naūrodski, Aleksander Olechnowicz, Izabela Styczyńska, Krzysztof Głowacki, Jarosław Neneman, Pawel Swianiewicz, Andrzej Raczko, Kateryna Karunska[1]

## ABSTRACT

Belarusian economy has been stagnating in 2011-2016 after 15 years of a high annual average growth rate. In 2015, after four years of stagnation, the Belarusian economy slid into a recession, its first since 1996, and experienced both cyclical and structural recessions. Since 2015, the Belarusian government and the National Bank of Belarus have been giving economic reforms a good chance thanks to gradual but consistent actions aimed at maintaining macroeconomic stability and economic liberalization. It seems that the economic authorities have sustained more transformation efforts during 2015-2018 than in the previous 24 years since 1991. As the relative welfare level in Belarus is currently 64% compared to the Central and Eastern Europe (CEE) countries average, Belarus needs to build stronger fundaments of sustainable growth by continuing and accelerating the implementation of institutional transformation, primarily by fostering elimination of existing administrative mechanisms of inefficient resource allocation.

Based on the experience of the CEE countries' economic transformation, we highlight five lessons for the purpose of the economic reforms that Belarus still faces today: keeping macroeconomic stability, restructuring and improving the governance of state-owned enterprises, developing the financial market, increasing taxation efficiency, and deepening fiscal decentralization.

[1] Sierž Naūrodski is President of CASE Belarus, Aleksander Olechnowicz is Vice-President of CASE Belarus, Izabela Styczyńska is President of CASE, Krzysztof Głowacki is Economist at CASE, Jarosław Neneman is former deputy Minister of Finance of Poland, Paweł Swianiewicz is Professor at Warsaw University, Andrzej Raczko is former Minister of Finance and member of the board of National Bank of Poland, Kateryna Karunska is Economist at CASE.

## INTRODUCTION

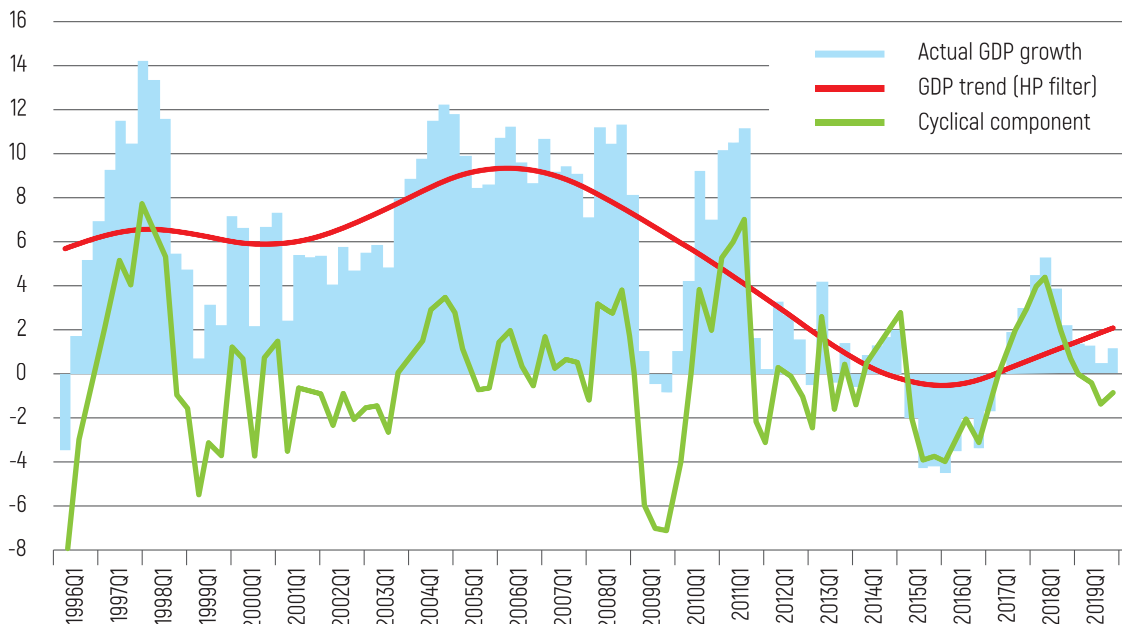
Feedback from the Central and Eastern European countries may be very useful for Belarus at this point. Today, 30 years after the beginning of the economic transformation, the relative welfare level in all the post-socialist countries of Central and Eastern Europe is higher than in the so-called times of socialism. Despite not being a completely homogeneous group, the CEE countries share a common experience of economic transition. Evidently, countries that started reforms earlier and acted consistently and fast achieved the greatest successes. The continuous development of the institutional environment and structural competitiveness has been a key element of the CEE economic transition, ensuring convergence with the Western European economies. Poland was a pioneer of economic transformation that started in 1989, and it achieved one of the best economic and social results among almost 30 post-socialist countries. The institutional component of the Polish economic reforms proved to be of the most long term nature, both in terms of implementation and effects, still ongoing nowadays.

## 1. THE SPECIFICS OF BELARUS'S ECONOMIC PERFORMANCE IN 2014-2019 AND THE NEED FOR FURTHER REFORMS

**After the 2014 economic crisis, the Belarus authorities changed their macroeconomic strategy and supported further economic transformation.** In fact, the economic authorities have sustained more transformation during 2015-2018 than in the previous 24 years since 1991. Among the key changes were introduction of monetary base targeting (IMF, 2018), cutting soft budget constraints (Kruk, 2019), reduction of excessive employment in SEOs and limiting the nominal salaries growth within productivity limits in SEOs (Chubrik, 2018).

**As a result, economic growth in Belarus has decreased and stayed in the range of 2 3% per year in 2017-2019.** The Belarusian economy has been stagnating since mid-2011 after 15 years of a high annual average growth rate. In 2015, after four years of stagnation, the Belarusian economy slid into a recession, its first since 1996, and experienced both cyclical and structural recessions (Figure 1). Due to an increase in the cyclical component in 2010-2011, 2014, and 2017-2018, Belarus has returned to real growth rates since 2017 (+2.5%). The fact that the Belarus economy for the first time faced both cyclical and structural recessions at the same time suggested that the nature of the December 2014 crisis was more fundamental and different from those encountered before.

**Figure 1. Belarus's real GDP growth in 1996-2019 and its decomposition, %, Q/Q**

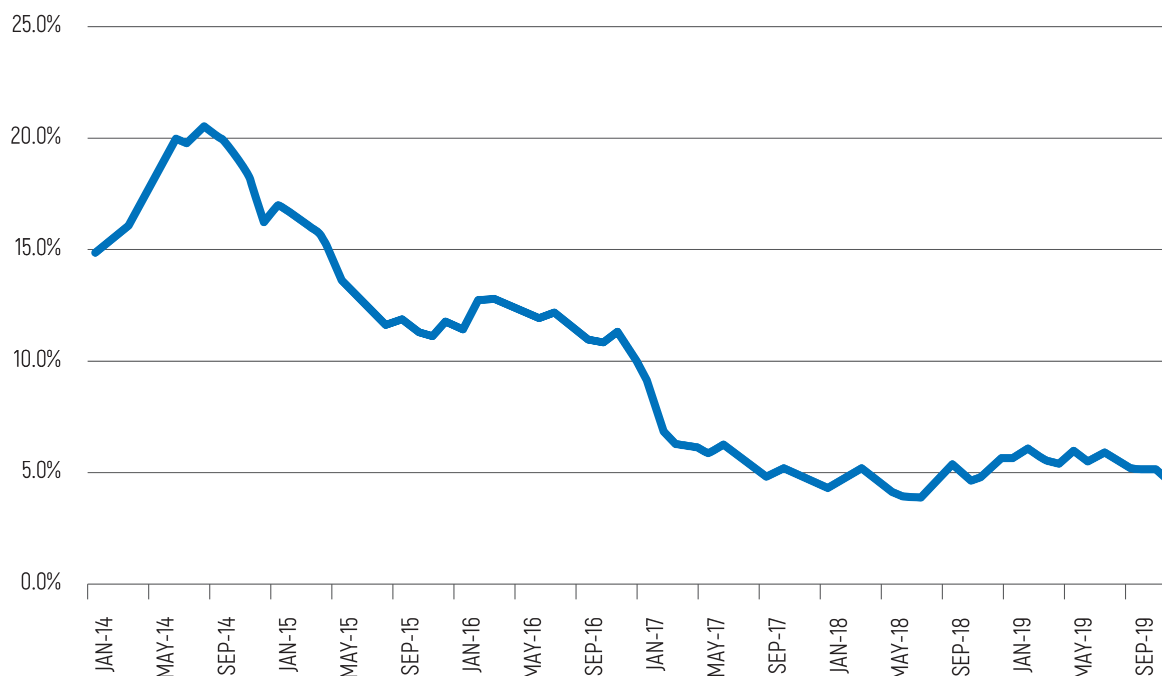



Source: own calculations based on the data from Belarusian Statistics Committee

**The 2014-2015 recession required the government to use different growth stimulation tool sets after 2015, sometimes contradictive to one another.** Overcoming the structural recession urged a set of structural (institutional) reforms in 2015-2016, mostly liberalization (alleviating the administrative and regulatory business environment; see, for instance, Kruk, 2019) and macroeconomic stabilization as a result of a tighter monetary policy (National Bank of Belarus (NBRB) introduced monetary targeting in 2015 as part of the strategy to introduce inflation targeting; the NBRB's basic interest rate increased from 20% to 25% in early 2015). Fighting the cyclical recession involved fostering domestic demand in 2017-2018, supported by an increase in savings and investments (Kruk, 2019).

**The economic growth in 2017-2019 was mostly spurred by domestic demand (mainly consumption) while net exports negatively contributed to GDP.** Throughout the period of recovery growth since 2017, household consumption fueled the GDP growth along with smaller contribution of gross fixed capital formation (IPM, 2019). However, due to high sensitivity of import demand to growth of domestic demand in Belarus, net exports showed negative dynamics in 2017 2019, unlike in 2015-2016 (Kruk, 2019). Demand driven growth also urged accelerating inflation in late 2018-early 2019 (Figure 2).

**Figure 2. CPI in Belarus in 2014-2019, %, y/y**



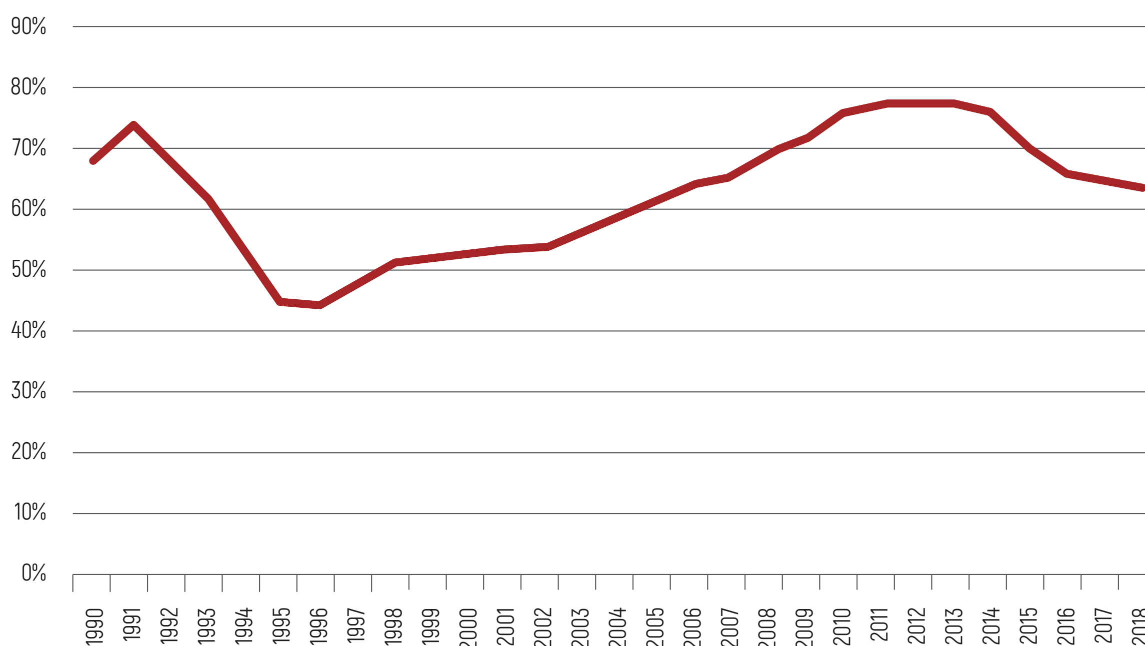

Source: own calculations based on the data from the Belarusian Statistics Committee

**To create stronger fundaments for sustainable growth, the Belarusian economic authorities should accelerate the implementation of institutional transformation, primarily by fostering elimination of existing administrative mechanisms of inefficient resource allocation.** There are clear differences in the rules of the game for the two segments of Belarus economy: public sector and private sector. The public part of the economy (unspokenly) provides employment, as well as the scale of production, budget, and foreign trade flows (see, for example, Dobrinsky et al, 2016 or IMF, 2018). The private part of the Belarusian economy is being currently considered by the economic authorities mostly as a growth driver (see, for instance, Kruk, 2019). The criteria of efficiency, competitiveness, and opportunities for generating growth need to be further unified for both segments, and hard budget constraints for SOEs and state-owned banks need to be introduced, in order to create a more sustainable economic growth in Belarus. Feedback from the Central and Eastern European countries may be very useful for Belarus at this point of time.

## 2. FEEDBACK FROM THE CEE COUNTRIES: KEY ECONOMIC TRANSFORMATION ACHIEVEMENTS

**The development gap between Belarus and the CEE countries is currently growing.** There has been a downward trend in GDP per capita (PPP) of Belarus relatively to the CEE countries since 2012. Despite the GDP growth in Belarus in 2017-2018, the relative welfare level in Belarus compared to CEE countries continued to decline, though at a slower pace. In total, in 2013-2018 Belarus lost about 15 percentage points to relative welfare in the CEE countries (Figure 3).

**Figure 3. Belarus GDP per capita (PPP, constant 2011 international USD) in 1990-2018 as % of the average for the CEB countries (Central Europe and Baltics).**




Source: own calculations based on data from the World Development Indicators database

**Despite not being a completely homogeneous group, the CEE countries share a common experience of economic transition.** Building on the need to address high inflation and missing market economy fundamentals in the early 1990s, their transformation has been driven by a combination of (1) macroeconomic stabilization programs; (2) establishment of well functioning institutional frameworks; (3) elimination of price controls and significant reductions of state subsidies; (4) restructuring and privatization of state-owned enterprises; and (5) liberalization of foreign trade and of the financial sector (Matyska, Potocka, and Samecki, 2019). The later stages of the transition and the still ongoing process of convergence with the Western European economies have revolved around the development of the structural competitiveness and the right institutional environment (Grela et al., 2017).

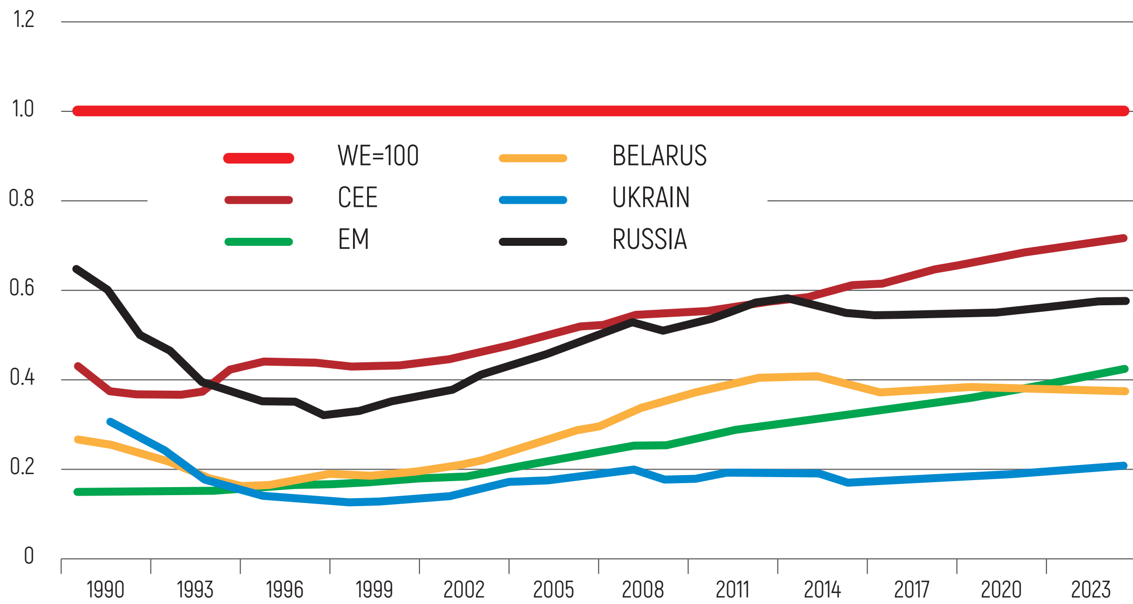
**As a result of the initial phase of the reforms, the level of inflation in the CEE countries decreased significantly, from the average of about 100% in 1990 to below 10% in 1998.** At the same time, the reforms induced foreign investment influx was fueling the current account deficits of the CEE until around 2007 2008. Although a natural consequence of the "catching up" process, the persistent current account deficits increased the CEE countries' external debt levels and heightened their vulnerability to external shocks. As a consequence, the CEE countries (except Poland) were among the most severely affected in the aftermath of the 2008 crisis, with an average decrease of GDP by about 14% in 2009 (Matyska, Potocka, and Samecki, 2019).

**Full convergence with the Western European countries is yet to be achieved, but it can be argued that the CEE economic transformation has yielded beneficial results compared to other emerging economies (EM), including most post-Soviet economies.**[2] Specifically, as Figure 4 demonstrates, the reforms have resulted in a significant and continuous improvement of welfare, with the distance of the CEE countries to Western European countries (WE)[3] in average GDP per capita dropping by about 30 percentage points between 1990 and 2020. At the same time, technological and organizational changes fueled by the structural reforms and improved governance of state-owned enterprises (SOEs) have led to a significant increase of labor productivity throughout the CEE countries (Figure 5), a crucial ingredient of long term competitiveness and the "catching-up" process.

2 E.g. Belarus, Ukraine, and Russia.

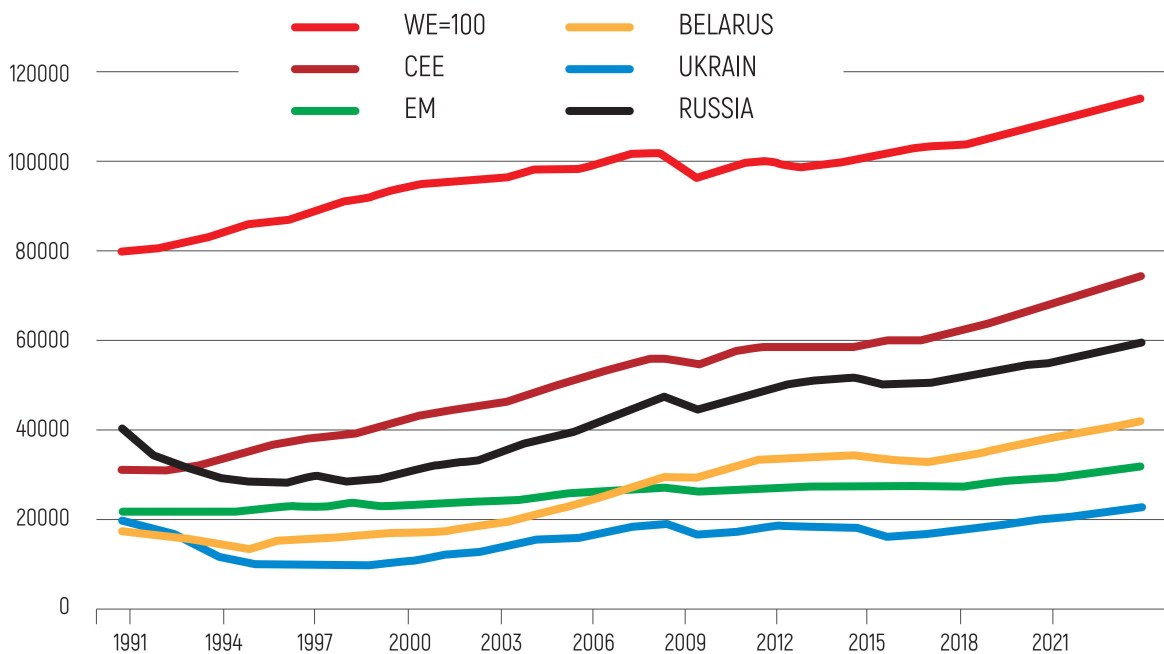
3 I.e. Austria, Belgium, France, Germany, Italy, Luxembourg, Netherlands, Portugal, Spain.

**Figure 4. GDP per capita (PPP).**




Source: own calculations based on the data retrieved from IMF. World Economic Outlook Database. Note: WE=1

**Figure 5. Output per worker (GDP, PPP)**



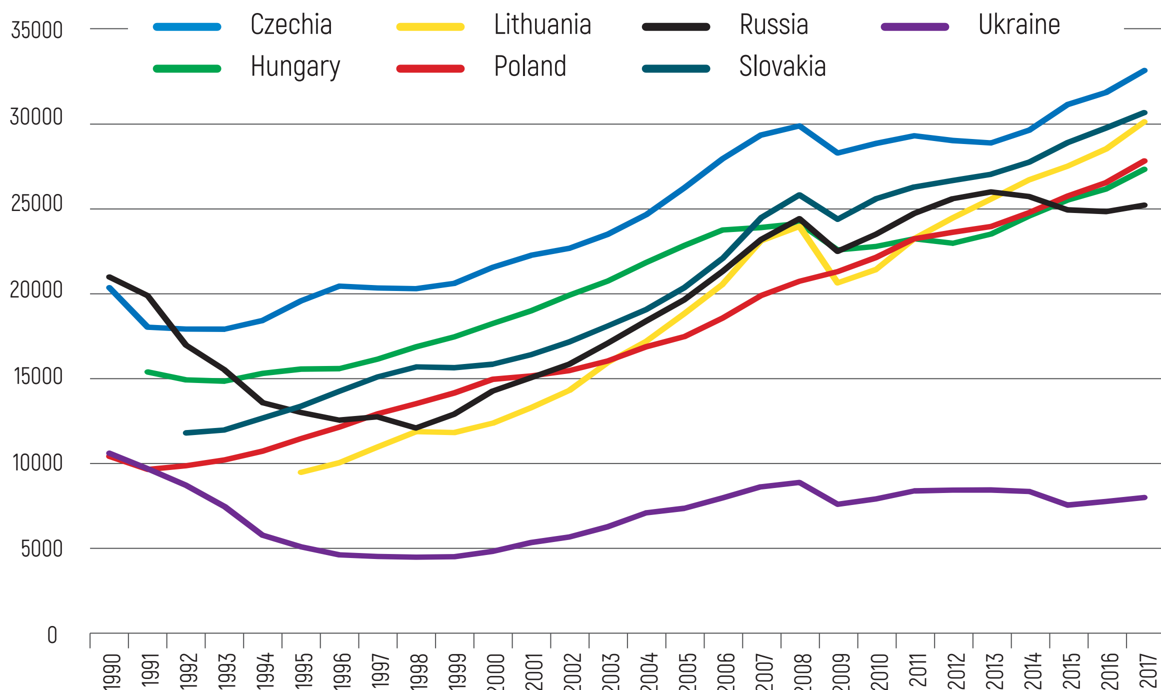

Source: ILO Statistics

While the EU accession (before and after 2004) has facilitated and fueled the transformation of the CEE countries, a number of internal factors have been crucial to the relative success of their economic transition. In particular, among the key internal factors that contributed to the transition success one should recall: 1) the resolution of the political elites to pursue the reforms despite the unpopularity of short term hardships, 2) flourishing private sector, as well as 3) significant improvements in the quality of education, especially at the tertiary level.

## THE CASE OF POLAND: KEY ACHIEVEMENTS

Poland started economic reforms in 1989 as a country with a centrally planned economic system and an autocratic political system. Over four decades of the economy run by bureaucracy rather than by market resulted in dramatic macroeconomic imbalances: high budget deficit (7.4% – Balcerowicz, 1995), heavy foreign debt, overemployment, wage pressures, severe goods shortage, and repressed inflation, which soon turned into hyperinflation (640% – ibid.). The starting situation was worse than in most other post-Communist countries, with GDP per capita lingering at the bottom of the reference group in 1990 (Figure 6).

**Figure 6. GDP per capita, PPP, constant prices (2011 international USD)**

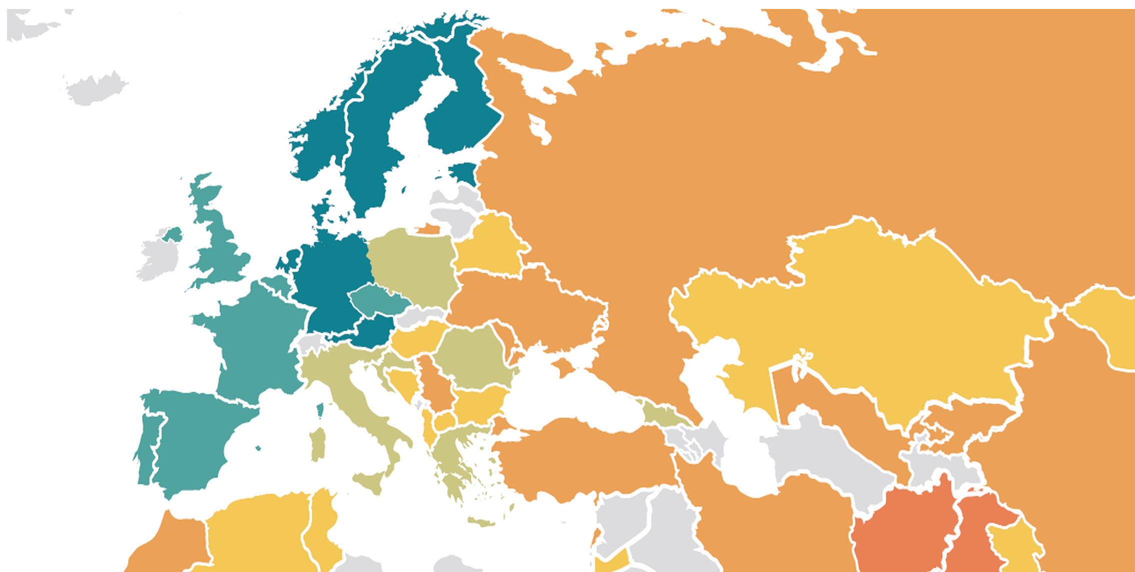



Source: World Bank (2019)

**Poland's economic recovery led the country to climb up in the GDP per capita rankings (Figure 6) and was based on a thorough and speedy reformatory process.** Dubbed the shock therapy, it consisted of three areas of reform: macroeconomic stabilization, microeconomic liberalization, and institutional transformation. **Macroeconomic stabilization**, targeted at bringing inflation under control and restoring the sustainability of public finance, was carried through by curbing the money supply, imposing wage controls, and removing subsidies (e.g. for energy). The goal of **microeconomic liberalization** was to replace the centrally planned economic decision making with a free market set of economic mechanisms. Microeconomic liberalization included introducing freedom of private business, dropping price controls, removing the privileged position of SOEs, liberalizing international trade, introducing currency exchangeability, and creating favorable conditions for foreign investment.

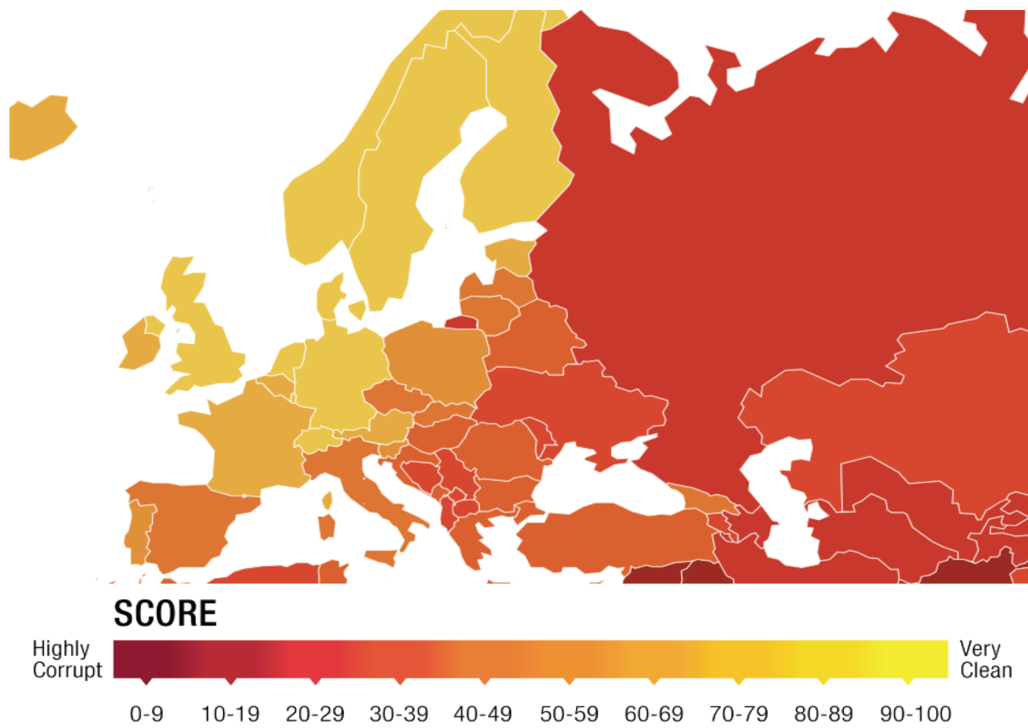
**The institutional component of Polish economic reforms proved to be of the most long term nature, both in terms of implementation and effects, still ongoing nowadays.** The **institutional transformation** saw the rule of law restored as the fundamental principle of social life, including economic activity. The rule of law, although recently declining, has manifested in protection of property rights, legal certainty, division of powers (including checks and balances), and independent judiciary system (Frye, 2001; World Justice Project, 2019 – cf. Figure 7) – institutions that promote economic exchange by increasing inclusiveness of transactions and decreasing their costs. A similar logic led to the entrenchment of the Central Bank as an independent institution, enactment of anti monopolistic legislation, and development of anti corruption mechanisms (cf. Figure 8).

**Figure 7. World Justice Project's Rule of Law Index 2019.**



Source: World Justice Project (2019).

**Figure 8. Corruption Perception Index in 2018**




Source: Transparency International (2019).

## 3. KEY LESSONS FOR BELARUS

Based on the experience of the CEE countries' economic transformation, it seems important to highlight five lessons for the purpose of the economic reforms that Belarus still faces today. Those are: keeping macroeconomic stability, restructuring and improving the governance of state-owned enterprises, developing the financial market, increasing taxation efficiency, and deepening fiscal decentralization.

### LESSON 1. TO KEEP MACROECONOMIC STABILITY

To ensure stability and sustainability of economic growth in Belarus, the macro prudential framework should be strengthened and, even more importantly, inefficient mechanisms of resource allocation should make room for more market oriented approaches.

**The macro prudential framework should create a wide path for improvement in terms of consistent medium term planning and fiscal rules.** To address these challenges, the fiscal rules should be coordinated across the central and the local levels of government to ensure coherency. Moreover, a debt anchor of a comprehensive scope, set at a sufficiently safe but at the same time realistic level, should be introduced. In Poland, for example, a 60% debt to GDP ratio is entrenched in the Constitution[4], prohibiting the general and local governments to take loans or provide guarantees above that value in total. Moreover, the Public Finances Act lays down the prudence thresholds of 55% and 60%, which, if breached, trigger countervailing measures such as a ban to increase wages or to index pensions and an obligation to prepare a corrective plan (Głowacki & Poniatowski, 2017).

**To rationalize the expenditure side of the budget, the lavish subsidies to enterprises and households must be cut down.** Not only are they a huge burden on the state budget, but subsidies to enterprises (whether allocated directly by state agencies or in the form of cross subsidies from more to less profitable entities, agencies, banks, etc.) also have a competition distortive effect in that they penalize performance.

**Foreign borrowing, by unlocking additional opportunities for consumption and allowing for technology imports, may seem advantageous in the short term but is risky in the long term.** In Poland, the consumption and investment spree of the 1970s, financed by foreign debt, led to severe macroeconomic imbalances a decade later, becoming a contributing factor to the fall of the Communist government. The noxious effects of foreign debt are also beginning to weigh on the Belarusian economy, and any future borrowing abroad should be carefully considered.

[4] Art. 216, clause 5.

**Due to its inflation generating effect, wage growth that exceeds productivity growth is a considerable risk factor for macroeconomic stability.** Such growth is mainly driven by the centrally planned wage targets (IMF, 2014), which, being an inadequate mechanism of matching wage growth with productivity growth, should be gradually eliminated. In Poland, the wage control of the early 1990s was carried through using a temporary tax dubbed popiwek[5], which applied initially to all enterprises and later exclusively to SOEs.

**Finally, as the economic theory suggests and the CEE countries' experience confirms, macroeconomic stabilization is intimately linked with continuous microeconomic liberalization.** Without the efficiency maximizing effect of the latter, the Belarusian economy will continue to consume more than it is able to produce, undermining the budget or risking social discontent in case of sudden cuts. For that reason, domestic policy makers are encouraged to eliminate price controls and equalize opportunities for all market participants, for both private and public segments of Belarusian economy.

## LESSON 2. TO CONTINUE STATE-OWNED ENTERPRISES RESTRUCTURING

While state-owned enterprises (SOEs) continue to serve as one of the main instruments of implementing broad socio economic policies in Belarus, the SOEs' reliance on the state support creates fiscal pressure and undermines long-term development. As evidenced by the performance of the Belarusian SOEs in the machine-building sector, persistent state support to inefficient companies significantly limits the potential for organizational and technological innovativeness, undermining long term competitiveness and resilience of the entire economy (Favaro et al., 2012). In this light, as the experience of the CEE countries confirms, despite short term hardships and various side effects, a comprehensive restructuring is required to transform the inefficient SOEs into self sustained entities and to create conditions under which competition regulated by market forces can freely operate (Richmond et al., 2019).

**Fundamentally, the rules of the game for SOEs and private enterprises should be equalized, including with regard to subsidization, access to capital, and treatment by authorities.** Because the Belarusian SOEs consistently underperform as compared to private enterprises (IMF, 2017), the continued state support they receive misallocates resources and should be phased out. Instead of enjoying the guarantee of continued operation irrespective of performance, SOEs should be made able to undergo bankruptcy, and, eventually, solid anti monopolistic legislation should be adopted to enable a level playing field in the economy.

**The SOEs restructuring has to focus on the strengthening of the corporate governance through clear separation between the ownership and the regulatory functions in**

[5] The instrument was officially called the tax on excessive salary payouts (podatek od ponadnormatywnych wypłat wynagrodzeń).

**order to improve the efficiency and transparency of the SOEs.** The restructuring should provide for (1) a clear delimitation of the commercial and non-commercial (e.g. social, cultural) objectives of the SOEs; (2) decommissioning of unnecessary production assets (infrastructure and machinery) and of non productive assets (holiday centers, medical clinics, kindergartens); and (3) reduction of excessive capital allocation. Furthermore, to address the structural weaknesses of the operational environment of the SOEs, there is a need to develop a unified government oversight of the SOEs assets and strengthen the supervisory boards, fiscal risk assessment, and the reporting capacity of the authorities (IMF, 2017).

To offset potential shortcomings and social effects (mainly job shedding) of the restructuring, the process has to be closely coordinated with broad structural reforms in Belarus, including inter alia development of the financial sector, improvement of the accounting and reporting regulations, legal and institutional environment, vocational education as well as support to private sector and entrepreneurship.

## LESSON 3. TO DEVELOP FINANCIAL MARKETS

The transition process from the centrally planned economy to a free market system had to change the role and the operation of the financial system. The main aim of the reform was a transformation of existing banks into financial institutions that could regulate economic relations via monetary instruments. The CEE experience clearly indicates that what matters in terms of financial development is a sequence of steps and a fast creation of a critical mass of changes to bring to life a more effective financial framework.

**First, clear, unified market rules of the game for banks and other financial institutions should be created.** According to market rules, management boards aiming at making profit adopt an interest and credit risk policy to market standards. Legal adoption of market rules speeds up competition in the financial sector and opens doors for private banks and non-banking institutions.

**Second, a prudential supervision policy for the banking and the non-banking financial sector avoids banking bankruptcy and enhances the stability of the financial sector.** A merger of financial supervision in Poland and other CEE countries into a single supervisory body allowed for a powerful and independent institution that limits the risk appetite of banks and financial companies. For instance, the Polish Financial Supervision Authority is a publicly financed entity serving as a single contact point and watchdog for all the segments of the Polish financial market. It has been credited with ensuring that Polish banks remained relatively healthy during the most recent global banking crisis by monitoring and responding to bank liquidity measures in the midst of the general slowdown in economic activity.

**Finally, internationalization has become an important stage of transition of the CEE financial sector.** Allowing foreign financial capital to take over local banks and open new financial institutions brought higher banking standards, delivered fresh capital, introduced modern management, new financial products, and modern technologies. Although top management was mostly "imported" together with foreign capital, basic staff of foreign banks was recruited from the local labor markets. This process resulted in a significant improvement of the quality of the banking labor force and had spill over effects for domestic banks.

## LESSON 4. TO INCREASE TAX SYSTEM EFFICIENCY

In the CEE countries, public sector accounts for 30-40% of the GDP. In general, the way in which tax and expenditure system is designed and runs matters a lot to economic welfare. Public debate about taxation is difficult as public understanding of taxes is limited, and policymakers tend to overuse taxes for political purposes. Mistakes in the tax design have long lasting consequences, as it is very difficult to correct them – those who benefit will fight. A few countries (e.g. Slovakia in 2004) managed to introduce a complex reform of the tax and social security contribution system, but a common practice is piecemeal changes to taxes.

**There is not a tax system that fits all, but experience shows that a good tax system should be based on simplicity, stability, and transparency.** In most cases, simplicity is possible and desirable. If a product, service or activity is to benefit from tax preferences, it is necessary to define it precisely – which is not easy. As the saying goes: "An old tax is a good tax". Every change in taxation, every switch from one regime to another is associated with high costs, and also a decline in efficiency. It is important for the regulations to be as comprehensible as possible for every single citizen and business. Transparency increases people's sense of justice and thus helps improve tax ethics.

**Among tax theoreticians and practitioners, there is a consensus that a good tax system should be based on knowledge and should try to combine efficiency and equity.** The Mirrlees Review (Mirrlees et al., 2011) identifies 3 basic principles of modern taxation. They refer to the UK, but are still of great importance for the less developed countries, including CEE and Belarus (Gomułka, Neneman, Myck, 2017). The first is neutrality. With some exceptions (alcohol, cigarettes, fuels), similar activities should be taxed similarly. This applies to goods, services, savings, investments, etc. One should always remember that people react to incentives and will attempt to adjust their behaviors to the signals sent to them by the tax system. Therefore, it is advisable to have a broader base and a lower rate. In the case of income taxes, this means taxing income from all the sources at a lower uniform rate, rather than having a complicated system with differentiated rates for each source of income plus tax expenditures for, say, R&D

or new investment. Neutrality has one more significant advantage: It lowers the compliance costs and significantly limits the phenomena of tax avoidance and evasion.

The second fundamental principle of the modern tax systems is progressivity. The idea behind this is not to punish people with high taxes but rather to distribute fairly the burdens of taxation, so that those who are in a better situation bear a higher tax burden. Finally, taxes must be discussed as a system. Not every tax needs to be „greened" or progressive for the system to be green and progressive. One must consider the interrelation of taxes and social security contributions. Direct expenditures are more transparent and usually far more efficient than tax expenditures (e.g. reduced VAT rates). Following this principle, it is better to have a uniform VAT rate and to redistribute it via income and property taxes as well via direct social transfers.

## LESSON 5. TO DEEPEN FISCAL DECENTRALIZATION

There is evidence in academic literature that a more fiscally decentralized state functions better than a centralized one. Several studies (also conducted in Europe) demonstrate a positive correlation between decentralization and GDP growth as well as happiness of local communities, and a negative correlation with the corruption index. Decentralization promotes three important values: 1) democracy (the existence of sub-national elected authorities limits the omnipotence of the central power, and local jurisdictions serve as "schools of democracy" for citizens); 2) participation (many more people are directly involved in decisions on public affairs, e.g. as local councilors, but also local authorities are closer to citizens, allowing for a more direct impact, consultation, and involvement in the policy making); 3) effectiveness – this argument may be justified by several partial arguments: (a) decisions are made closer to their results, which improves precise estimation of their results, (b) decisions might be better tailored to specific local conditions as well as to diverse local preferences, (c) various solutions in different places allow testing innovative policies. The experience of the economic transformation in the CEE countries suggests that a good system of financing sub-national jurisdictions should be based on a number of rules that together constitute a strong, decentralized fiscal system.

**Allocation of tasks among the tiers of government should follow the subsidiarity principle** (an upper tier takes care of tasks which are too complicated for a lower tier; upper tiers support lower ones in performing their tasks) and should take into account territorial organization of the state (e.g. if there are many very small municipalities, more complicated tasks related to social services can hardly be decentralized, which is possible in the case of larger local jurisdictions).

**Sub-national jurisdictions need to have revenue sources, which are adequate to their tasks. A large proportion of local revenues should originate from own sources, i.e. such**

**which are controlled and collected by local governments for an indefinite period, and which are connected to local economy (local tax base).** Such an arrangement has several positive potential consequences: (a) it promotes accountability of public authorities towards local citizens, (b) it promotes a prudent level of spending (increasing local taxes is always politically difficult), (c) it enables matching the local financial policy with local preferences, (d) it reduces the pressure on the overall level of public spending (helps to eliminate fiscal illusion), (e) it makes local governments more interested in promoting local economic growth.

**At the same time, relying on own revenues of local government – regardless what exact revenue sources form the base of local budgets – increases inequalities between rich and poor territories.** That is why the “own revenue” system has to be accompanied by transfers (grants) to the local government system, especially in the form of an equalization grant that supports local jurisdictions with the lowest tax base. The equalization system should take into account not only the level of the local tax base, but also a variation of spending needs related to the various parameters of natural environment (e.g. population density) and social structure (e.g. age structure).

**Local governments have to be relatively autonomous in their decisions on spending allocation.** A vast majority of transfers should have the character of general-purpose grants rather than specific-purpose (conditional) transfers. Apart of limiting the autonomy of local governments, specific purpose transfers’ allocation has a tendency towards political corruption biases.

**Capital revenues (sale of communal property, borrowing from banks, issuing local bonds) must not be spent on current expenditures but on investment projects only.** The proper mix of local autonomy and state supervision should promote prudent local borrowing policies, allowing financing development projects but preventing excessive debt.

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