The impact of EU association on industrial policy making
Campbell, Carolyn
East European Quarterly; Winter 2001; 35, 4; ProQuest Central
pg. 499

East European Quarterly, XXXV, No. 4
January 2002

THE IMPACT OF EU ASSOCIATION ON INDUSTRIAL POLICY MAKING

Carolyn Campbell
Washington, DC

> *All in all, the period after 1990 is characterized by various changes in the structure of the Polish economy, which are sometimes quite dramatic and which proceed in different directions. Still, these changes were not, to any extent, a result of the industrial policy understood as a deliberate influence on the structure of production exerted by the Government. On the contrary, the Government declared very early that it did not intend to conduct such policy. There is well known in Poland an official statement made by the then Minister of Industry: 'Our industrial policy is the lack of industrial policy'.*
>
> Marek Belka and Stefan Krajewski
> *Industrial Policy in Poland* (1996)[1]

This article explores the effects of EU association on industrial policy making in the new Poland. As the country struggled to rebuild, it set its sights on the EU, allowing the goal of EU membership to bolster the conversion from socialism to capitalism. Despite occasional digressions, the commitment to EU association prevailed over attempts to develop active industrial policies and successive Governments were able to stay a pro-market, pro-EU course in the face of demands for intervention. As case studies this article examines two key Polish industrial sectors, textiles and steel, both of which were important sectors under central planning and both of which were designated as "sensitive" sectors in the association negotiations. While the textiles sector adjusted relatively well to the new economic environment, the steel sector adjusted relatively poorly, complicating the Government's struggle to liberalize the sector. These case studies reveal that even where domestic opposition to reform was strong (e.g., in sectors facing high social costs), government leaders were able to preserve their autonomy domestically using the "shield" of mandatory harmonization with EU policies.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Formerly confined within the Soviet bloc for over four decades, the newly opened Poland underwent an industrial policy-making revolution during a period wrought with dilemmas – the difficult task of converting from a socialist system to a market economy and the ongoing struggle to consolidate a fledgling democratic political system. As Polish policy makers liberalized industrial trade under the Association Agreement, they relinquished direct control over industry through privatization and market-based reforms. This extrication of policy makers from industry was facilitated by the lack of a well-defined post-communist system of lobbying or interest group organization through which to consolidate opposition. The Government resisted domestic pressures for intervention in line with the Association Agreement, revealing that a country in transition and seeking membership may be more predisposed than other recent EU member states to abide by the policy-making constraints of the EU in return for greater chances of membership.

THE EU AS POLICY-MAKING SHIELD

Liberal Intergovernmentalism

The theory of "liberal intergovernmentalism," which asserts that membership in the EU strengthens the "national executive" vis-à-vis other domestic actors, provides a valuable framework for exploring the influence of EU association on industrial policy making in Poland. According to the theory, cooperation at the supranational level in the EU redistributes "domestic power resources" between the government and society in favor of a discrete executive, meaning not only the head of state or government or highest political authority in a particular issue area, but those policy makers who participate directly in international negotiations and institutions (Moravcsik 1994).[2] By conferring domestic "agenda control," policy coordination among EU member states allows national executives to determine which issues receive attention and to veto proposals that conflict with external agreements. Whereas other theories assert that international cooperation weakens national executives ("ties their hands"),[3] liberal intergovernmentalism contends that it empowers them and allows them to relax domestic constraints ("cut slack") imposed by legislatures, interest groups and other societal actors, particularly where domestic opposition is weak. Consequently power redistribu-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

tion is widespread in the EU, where deepening of integration has removed many issues from the domestic to the supranational level, subjecting them to less legislative, judicial and public oversight.

Several time- and country-specific features of Poland amplify the central tenet of liberal intergovernmentalism—that "[r]ather than 'domesticating' the international system, the EC 'internationalizes' domestic politics" (Moravcsik 1994). First, domestic constraints on the "executive" were extremely loose in Poland's fledgling post-communist democracy, as reflected in the free rein policy makers enjoyed in relation to domestic legislators, interest groups and other societal actors while negotiating the Association Agreement. Deputy Prime Minister Leszek Balcerowicz, the principal economic policy maker at the time,[4] described the situation as a period of "extraordinary politics," during which "major discontinuities, i.e., liberation from external dependence and a political liberalization, produce a special state of mass psychology and a corresponding state of political system," resulting in an abnormally high level of readiness to accept radical economic measures (Balcerowicz 1995). Thus, while no powerful opposition parties or interest groups existed to limit the freedom of the Government to fashion economic policy, the degree of national consensus on the desire to join the EU shifted power not only toward the national executive in the traditional sense but also toward all high-level policy makers focused on EU association.

Second, because of the dramatic nature of the shift from socialism to a market economy and the lack of any recent experience with capitalism, the Government was able to limit the range of considered policy choices to the "liberal" choice set, which conformed the national ideology to internationally-prevailing norms and contributed to policy-making stability. Meanwhile, the domestic agenda was volatile, with a wide range of major issues being introduced daily, while information regarding external economic policy was not widely disseminated outside the Government due to severe technical constraints. Because of the distortions of central planning and the extreme isolation of the Polish economy within the former Soviet trade bloc, the Polish economy faced a more profound transition than previously associated member states, magnifying the economic effects of association. Yet, with mere associate status, the Government

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

remained an outsider to the EU decision-making system, ensuring that its hands were "tied" more tightly than full member states.

Preference for Laissez-Faire Economics

The sweeping Economic Transformation Program—alternatively referred to as the "Balcerowicz Plan" or "shock therapy"[5]—embraced a neo-classical approach to reform. Reflecting an aversion to state intervention, policy makers in charge of designing the initial reforms relied almost exclusively self-adjusting market mechanisms and private property as the means to achieve the transition from a command economy to a market economy. The three main components of the Program—stabilization, liberalization and privatization—were designed to reduce or eliminate state involvement in the economy. This approach manifested a simple *laissez-faire* rationale for Poland's new political economy: The role of government should be limited to providing a stable, neutral incentive system and to overseeing ownership changes in order to avoid a repetition of the errors committed under central planning. The Government made liberalization of industrial trade a cornerstone of the economic reforms, recognizing that Poland's favorable geographic location—its border with Germany—had the potential to facilitate trade with the West, and a core objective was to build "a modern market economy capable of soon joining the successful economies" of the EU (World Bank 1992).

As political leaders toiled to install the foundations of a market economy, a strong undercurrent swept Polish society in favor of association with the EU. This desire was captured by the observation of Poland's foremost Western economic advisor, Professor Jeffrey Sachs, that "[t]he urge to harmonize with and eventually join the European Community has deep roots. Poland desires to regain its place in the mainstream of European society and culture. The slogan of the revolutions of 1989, after all, was 'return to Europe'" (Sachs 1992). With the basic mechanisms of the economic reforms in place, policy makers began to exploit the vast popular support for their historic mission to pursue EU association and eventual membership, a mission that strongly correlated with their domestic policy agenda.

In approaching the negotiating table, Polish leaders were armed with a broad mandate and returned with an agreement hailed as a "success" by virtue of the simple fact that it established an association. Coinciding with the Government's basic policy preferences, the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

obligation to harmonize Polish policy with EU policy bolstered domestic policy-making legitimacy. The implications for policy-making autonomy were clearest where the Agreement adopted free-market prescriptions without deviation, which applied to all but those sectors considered "sensitive" by the EU. However, as the rigors of liberalization emerged, the Government experienced an ongoing dilemma between heralding the Agreement as an inviolable pact and appearing compassionate toward emerging domestic opposition. Whereas the public response to association in other countries such as Portugal was "ambiguous" in many respects (Tsoukalis 1991), in Poland the response was definite and unwavering. The Government often strove to go beyond the letter of the Agreement, pursuing related initiatives to facilitate accession.

Industrial Policy Making During Transition

The *laissez faire* policy-making atmosphere permeated industrial policy, as evidenced by Polish Minister of Industry Tadeusz Syryjczyk's avowal that "the best industrial policy is no industrial policy" (Kolodko 1996).[6] Transitional Polish industrial policy consisted of withdrawing the state's hand from industry after decades of deep intervention; and where new "positive" acts were used they embodied substitution of a lighter hand for a formerly heavy hand. Poland had inherited an industrial structure characterized by excessive development and geographical concentration of heavy industries, underdevelopment of high technology, service and consumer industries, and extreme horizontal and vertical integration. The implementation of radical economic reforms did not result in the spontaneous adjustment of this structure (Jakobik 1993). Moreover, under central planning the authorities encouraged, and the system necessitated, horizontal integration and collusion (Joskow et al. 1994), requiring the Government to make market-oriented corrections in order to effect the transition that were distinguishable from intervention in the traditional sense.

DOMESTIC PRESSURES FOR GOVERNMENT INTERVENTION IN INDUSTRY

As the Polish economy opened to competition, severe economic imbalances developed in the industrial sector. During the first year of the reforms, gross domestic product had fallen more in industry than

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

in the rest of the economy and the adjustment behavior of state industrial enterprises was diverse, with some enterprises performing at a much higher level than others. This resulted in "the separation of a group of enterprises permanently failing to achieve positive gross profitability" (Socha and Sztanderska 1994). In 1992, the Government relaxed certain macroeconomic austerity measures, allowing the budget deficit and money supply to expand, and aggregate industrial production began to increase. By operating according to the "principle of self management" by employees, most state industrial enterprises had little incentive to lower their labor costs or expenditure levels.[7] While some industrial segments began experiencing an economic recovery after 1992, others, particularly in contracting sectors, voiced concern over the growing Polish-EU trade deficit.

Having given the first post-communist Government considerable breathing space, workers lost patience with the reforms as productivity and growth declined and unemployment increased. The initial elation over democratic freedom eroded and as Solidarity splintered into its rival factions, workers' groups and employers in domestic state enterprises began to oppose the economic reforms, pressuring the Government to intervene. Between 1991 and 1995, the Government requested few serious adjustments to the asymmetrical formula of trade liberalization. But in threatened sectors, enterprises increasingly sought protection under the "restructuring clause" (Article 8) of the Association Agreement, which allowed the Government to implement "exceptional measures of limited duration" on imports of EU products competing with domestic infant industries or sectors undergoing restructuring or facing difficulties.[8]

Viewing this clause as a discretionary instrument of trade protection, the petroleum refining, steel, pharmaceuticals, fertilizer, banking, and insurance sectors all lobbied the Government for some form of temporary protection. The Government resisted most calls for protection, recognizing, as Prime Minister Jan Bielecki explained, that "the provision of temporary protection pushes the time frame for accession further into the future." Strengthening the Government domestically, the EU Commission warned that any increase in protectionism by appeal to the restructuring clause would delay the process of Poland's accession to the EU (Oxford Analytica 1996). The EU's strong admonition helped the Government remain faithful

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

to the market model prescriptions underlying the Association Agreement. The Government refrained from employing sector-selective policies or trade protection on any real scale,[9] invoking the restructuring clause only rarely, in the steel and oil refining sectors, and in two or three minor instances in relation to telecommunications equipment.[10]

Where increases in unemployment were potentially politically lethal, Government resistance was more difficult. Beginning in 1993, after the reformed communist parties—SLD and PSL—were elected to a majority position in the Sejm and the country's association commitments started accelerating, the Government came under pressure from various constituents to develop and implement more active industrial policies. Since management of most state enterprises remained unrestructured, the system of industrial relations posed an obstacle to reform. Management in industrial enterprises was relatively weak, nominated by employee councils and legally prohibited from undertaking lockouts or other actions to offset the power of employee unions. Thus, the Government could not rely on managers to deal with dissatisfied workers. In most cases, the Government continued to liberalize industrial trade despite the obvious adjustment difficulties state enterprises were experiencing. When public disfavor peaked, the pro-reform parties sometimes even "blamed" the EU for the economic woes of certain sectors, thereby shrugging off any personal responsibility for the failure to intervene.

Recognizing the EU's power to strengthen the Government against more powerful lobbies, Polish Foreign Affairs Minister Dariusz Rosati agreed to prohibit the introduction of unilateral protectionist measures in the fuel, steel and motor industries. The Government also promised that restructuring plans for further sectors (other than oil) would be discussed with EU officials in Brussels before their adoption (Oxford Analytica 1996). EU officials shored up the Government's resistance to protectionism, clarifying that deviations from the requirements for Polish accession would not be tolerated. Hans van den Broek, the EU Commissioner responsible for Central European integration, reiterated the "no slippage" principle, stating that the Central European countries "cannot assume that enlargement will go ahead under any circumstances at an early date for broadly political reasons, or that serious shortcomings in preparations

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

for membership will be taken care of by derogation or exceptions from Union rules" (Green 1996).

ATTEMPTS TO DEVELOP COMPREHENSIVE INDUSTRIAL POLICIES

In the market-oriented Polish policy-making environment, the Government avoided a pro-active industrial policy program in the Western interventionist sense, limiting its export promotion policy to management of the exchange rate. Professor Benjamin Slay discerned six phases of industrial policy development beginning in 1990 that fell short of a comprehensive industrial policy. The first three phases involved assessing the state of industry and consisted, respectively, of a "liberal approach" to economic policy, relying on market forces and privatization to induce spontaneous adjustment and restructuring, development of sectoral privatization plans, and systematic ranking of enterprises (identification of "winners" and "losers"). The next three phases appeared more interventionist, involving privatization through restructuring of small- and medium-sized enterprises, bank restructuring, and development of a social pact, the so-called Pact on State Enterprises in the Process of Privatization, among the Government, trade unions and employers. But only the first phase, basically a non-industrial policy, was fully implemented (Slay 1993).

To distinguish themselves from the liberal parties, the reformed socialists elected to power in the Sejm in 1993 began to consider comprehensive industrial policies aimed at "increasing the efficiency, competitiveness and innovative character" of industrial enterprises and reducing the share in industry of energy-intensive and ecologically-harmful enterprises. Several features of the programs exposed them as political promotions rather than real policy initiatives and reflected their development under considerable pressure. First, they covered a wide range of industries despite the shortage of resources and the diverse nature of the problems facing each industry, and little effort was made to prioritize among various sectors. Second, enterprises were included in programs based on heterogeneous criteria, and no economic evaluation was made of their chances of becoming commercially viable (Socha and Sztanderska 1994). Third, if taken literally, the proposed measures, which included cheap credit, tax concessions, trade protection and the acceleration of organizational

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

concentration through the creation of holding companies, would have distorted the emerging market-based economic system.

The Government made two attempts to develop a comprehensive transition-era industrial policy between 1990 and 1995. The Ministry of Industry and Trade issued the first industrial policy statement in September 1993 as part of the broader policy statement entitled *Strategia dla Polski.* Largely a propaganda piece, the first industrial policy statement had twelve strategic goals, ranging from slowing recession and providing a stable economic environment to increasing exports and enhancing the competitiveness and efficiency of Polish enterprises. Then, in an effort to hold onto power in the face of spreading domestic industrial discontent, in 1995 the Government undertook a politically-motivated review of domestic industrial restructuring. To further its political agenda, the Government proclaimed the need for greater use of so-called "promotional" measures, such as the restructuring clause, as opposed to mere remedial measures. The industrial policy program announced for 1995-97, entitled "International Competitiveness of Polish Industry," philosophically declared that while industrial enterprises were responsible for achieving their own competitiveness, the Government should create conditions to channel them toward desired activities. The program called for an analysis of the feasibility of invoking the "restructuring clause" of the Association Agreement and the "protective clauses" of the GATT/WTO applicable to developing countries.

Even the reformed socialists availed themselves of the EU as a policy-making shield and continued the liberal policies of their predecessors. The first and second industrial policies were essentially lofty, socio-political declarations intended to induce public favor without genuine implementation. They respected the country's association commitments and by issuing them the Government had no intention of jeopardizing its designs on the EU. Both policies expressly hedged implementation on conformity with EU association.[11] The first policy stated that "systemic solutions in the sphere of public expenditures complying with the rules of a market economy would be subordinated to the provisions of EU law" (Polityka Przemyslowa 1993), and the second called for "informational-organizational" assistance (such as studies and monitoring of export activity) and government stimulation of exports through assistance *allowable under*

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

the Association Agreement and the GATT/WTO. The following steel and textiles case studies illustrate the continuous nature of the Government's pro-EU stance and how association with the EU bolstered efforts to push through difficult industrial reforms.

CASE STUDIES OF POLISH STEEL AND TEXTILES SECTORS

The mass transformation from state to private ownership was particularly difficult for the more traditional industrial sectors that were uncompetitive by world standards. Steel and textiles were two sectors with strong potential to generate pressure for Government assistance and forestall liberalization and restructuring. Coincidentally, these sectors were also considered politically "sensitive" to the EU and the constraints on intervention imposed by EU association were patently binding. These sectors had been central to the country's industrialization under socialism and were politically important in terms of geographic concentration and employment. Consequently, they had received significant funding and resources, including generous allocations of workers and budget subsidies, under the system of central planning. Meanwhile, insulation from global competition had rendered the two sectors uncompetitive, and with the opening of the economy during the reforms, they faced fierce competition from both developed and newly industrializing markets around the world.

Steel Sector Restructuring Initiatives

The Association Agreement provided for the gradual elimination of all customs duties on steel products, beginning with a reduction to 80 percent of their basic level at the beginning of the first year, and proceeding with reductions to 60 percent, 40 percent, 20 percent, 10 percent and zero at the beginning of the third through seventh years, respectively. Customs tariffs notwithstanding, in the early 1990s steel imports from the EU to Poland rose six times while exports remained virtually unchanged. During the "transitional" years of protection, Polish steel plants failed to introduce major structural changes to help improve the quality of production, adjust capacity to demand, cut costs and raise profitability. Under pressure from the EU to reduce capacity and employment, the Government agreed to develop a rehabilitation program. However, devising such a program was an arduous task that took several years, with successive drafts provoking criticism from the EU and resistance from domestic enterprises.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The Polish steel sector in 1991 was technologically and financially distressed and widely recognized as one of the most difficult sectors to restructure, accounting for 123,000 employees or 2.9% of total industrial employment (Socha and Sztanderska 1994). The sector consisted of 26 enterprises, reduced to 25 by mid-1999, located mainly near the mines in Southern Poland. The two largest enterprises, Katowice and Sendzimir (in Cracow), together accounted for more than 70 percent of national steel output. Like other heavy industries, the steel sector was to be the foundation and driving force of the socialist economy and the industry grew to mammoth proportions under state sponsorship. In the socialist system, loss-generating mills were kept afloat by various state aids and insulated from world market competition. Most enterprises had been constructed prior to World War I, and lacking major upgrades in processing or management techniques, fell far below EU quality and technical standards (Jaroszynska 1993).

Successive post-communist Governments struggled to deal with the sectoral crisis after 1992. They introduced major changes in the industry's metallurgical section, which became one of the most advanced in Europe. They also eliminated around 8.3 tons per year of steel-making capacity and closed nearly all open-hearth furnaces and seven electric furnaces. The modernization completed in the raw-material stages of production, however, was not undertaken in the processing sector, which made final goods destined for the market. The unfavorable structure of production, reflected in an excess of semi-manufactured goods and a shortage of highly processed products, improved only marginally. Resulting in abnormally high fixed-asset depreciation, the average age of processing equipment was around 40 years. Continuous-casting lines accounted for just 60 percent of total capacity, against nearly 100 percent in the EU. Due to technical obsolescence, unit consumption of energy and raw materials was abnormally high, and restructuring was needed to improve management and reduce costs not directly connected with production.

The special focus on the steel industry in the Association Agreement reflected the EU's own difficulty in restructuring the sector. Despite often being labeled as a "sunset" sector in the EU, steel remained a significant component of EU industry in the 1990s, with production at over 140 million tons, sales invoices of over US$

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

90 billion and employment at approximately 350,000 (Masi 1996). Several policies at the EU and national levels had been devised to deal with the so-called "manifest crisis," referring to the development of excess productive capacity in the steel sectors of all member states, followed by member state attempts to alleviate the crisis through state aids to "national champions." During the early 1990s, several Directorates-General, including Competition, Social Affairs and Employment, Economic and Monetary Affairs, External Economic Relations, and Development and Cooperation, contributed to the formation of EU-wide remedial policies for the sector. These policies sought to eliminate excess capacity by linking permissible state aids to reductions in productive capacity. A comparison with the approach taken within the EU places the Polish policy in larger context.

Similar to the problems facing the Polish steel sector, the EU was hampered by the potentially large social dislocations associated with de-industrialization and the need to provide alternative employment, benefits and retraining for workers deemed redundant. The EU-wide policies had been developed in the 1980s after several failed attempts by the ECSC to alleviate the crisis, ranging from a voluntary deliveries program to direct price controls. In 1981, the EU developed a special code on state aids to the iron and steel industry, making restructuring a condition to aids in an effort to reduce overall production capacity and maintain capacity levels in areas for which there was no growth market (Masi 1996). When the special code proved ineffective, the EU in 1985 adopted strict rules prohibiting aids for operating budgets or investments, but exempting aids for carefully defined and strictly controlled research and technology expenditures, plant closures and investments designed to protect the environment. When capacity problems persisted, the European Commission decided in June 1987 to permit only aids designed to reduce excess capacity. Despite such measures, state aids in the form of debt restructuring persisted and capacity reductions consisted mainly of idle plant and production line closures.

Augmenting the EU's sensitivity to steel, EU steel sector policy was heavily criticized on a number of grounds. First, it used firm profitability as the main criterion for restructuring initiatives, a measure shown to engender serious distortions in competition among firms and diminish the eligibility of less profitable firms. Second, EU

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

policy failed to distinguish between private and public undertakings, aside from cases where the government afforded special treatment to a particular public undertaking. Finally, the EU allowed state aids as a temporary measure where designed to further restructuring and restore competitiveness through "commensurate" reductions in productive capacity. The EU counted as commensurate, however, reductions in plants not receiving any aids, and usually required the reductions to be made in recently modernized and thus indebted plants, entailing significant reductions in employment. Commenting on the EU's discretion over allowable state aids, a study by Anthony Masi noted that "in many Directorates-General, but particularly DG-IV, decisions that seemed on the surface to be ideologically pure and based soundly on the provisions of the relevant treaty, are in fact highly politicized and tend to favor the interests in Germany or France." It concluded that "precisely this interplay between the Community and national strategies has contributed to making the crisis of this sector a quasi-permanent feature of European economic policy making."

Accordingly, the Polish Government was less able to point to the EU as a source of legitimacy for a "hands off" approach to steel sector policy and instead relied on the dire state budgetary situation as a constraint. Faced with excess capacity, obsolete technology and overemployment, at the end of 1992 the Polish Ministry of Industry and Trade prepared a restructuring program for the steel sector, based on a study by 30 Western steel specialists. The study noted the sector's reliance on heavy industry and the former CMEA market, excess capacity, obsolete and low level of technology, lack of domestic competition, poor environmental condition and general inefficiency (raw materials factories situated far from the source of raw materials, energy and material waste, and high cost of credit service). The total cost of the restructuring program was estimated at US$ 4.5 billion, which the Government expected to be financed through steel enterprise funds and World Bank loans over a ten-year period.

The general aims of the restructuring program included organizational and ownership restructuring, technical restructuring, financial restructuring and employment restructuring. The specific priorities of the Government's restructuring program were as follows: (i) the reduction of capacity from 16.5 million tons to 11.7 million

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

tons of liquid steel, (ii) a production target for pipes aimed at 900,000 tons, (iii) the introduction of continuous casting, (iv) the rationalization of employment (through a reduction of approximately 80,000 workers) and the closure of all open-hearth furnaces, and (v) the privatization of profitable factories.[12] The program required tariff policies and quotas to be developed in accordance with the Association Agreement, although "during the period of restructuring some protection [would be] allowable." The more specific elements of the program provided for government guarantees "only for investor proposals for restructuring initiatives determined biannually within the state budget law."

Cognizant of its own deep intervention, the EU showed some flexibility in relation to Polish state initiatives to restructure the industry. In October 1996, the EU allowed the Government to maintain a nine percent import duty on steel products through the end of 1997. The EU also agreed to assist Poland with raising the remaining estimated US$ 2.5 billion in order to carry out the reforms, with the Government reserving the right to maintain high tariffs on steel products in the event the EU failed to secure the required financing.[13] Despite the EU's supportive stance, implementation of the restructuring program was delayed for several reasons. First, the structural features of the sector—large, long-term subsidies, high concentration, input overutilization, inflexible wages and strong labor unions—were deeply entrenched. Second, restructuring had politically unappealing social costs, particularly where firms dominated the towns in which they were located. However, the ownership structure placed the Government in control: In eight mills the Government remained the sole owner, 14 mills had strategic investors (only one, Lucchini-Warszawa, had foreign investment) and in several mills the Government held minority stakes (e.g., four companies in the National Investment Funds program, and those party to arrangements with the Stalexport and Impexmetal trading companies and banks).

These entrenched features induced the Government to drag its feet. Not surprisingly, given the politically sensitive nature of the sector in the EU, the EU's patience wore thin and European Commissioner Hans van den Broek began publicly referring to the lack of restructuring as a "bone of contention" between Poland and the EU. Even as pressure from the EU mounted, the shield of "mandatory"

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

harmonization with the EU was insufficient to stem the tide of domestic discontent. When the time for liberalization arrived under the Association Agreement, the Government stalled and continued to maintain the nine percent import tariff, while resisting EU demands that it be lowered to three percent as required by the Agreement. The Government's delayed compliance with the liberalization schedule showed that deeply sensitive issues could curtail policy-making autonomy, particularly where "mandatory harmonization" had an insufficient legitimizing function.

The Government's capitulation to the demands of domestic steel sector interests was short-lived and the import tariff was eventually lowered. Broader public support for EU association and the Government's own desire to pursue eventual membership allowed the Government to resume its market-oriented, pro-EU policy-making course and to consider only restructuring plans satisfactory to the EU, so that the EU once again became a policy-making "shield."[14] The Government still faced the challenge of reducing average tariffs from 6 percent in 1997 to 4 percent in 1998, 3 percent in 1999 and zero in 2000. Finally, in mid-1998, the Government introduced the "Program for Steel Industry Restructuring" running through 2005, which involved the following: (i) improving steelworks' economic efficiency and competitiveness; (ii) attaining production and development goals without relying on prohibited forms of state aid; (iii) orienting the industry primarily to meeting domestic demand; (iv) modernizing production techniques and adjusting capacity and employment to sales opportunities; and (v) providing an adequate level of environmental protection.

Strengthening the shield of mandatory harmonization with EU policy, the Program conforms the restructuring process to the terms of the Association Agreement. A major condition for program implementation is the reduction of production costs, to be achieved mainly through employment cuts. Through 2005, the program will cost an estimated US$ 2.7 billion, including US$ 1.9 billion for mill modernization, US$ .56 billion for mill recapitalization, US$ .068 billion for environmental protection and US$ 0.18 billion for the social safety net. As agreed with the EU, the bulk of these amounts must be obtained from the steelworks' capital, banks and strategic investors, rather than the state. Other sources of financing include aid

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

resources, bond and share issues, and environmental protection funds. While developed in cooperation with the European Commission, the program faces opposition from some member states, notably Germany and Spain, seeking to head off competition from Polish steel after Poland's entry into the EU. Thus, the steel sector woes are expected to continue, although the first signs of improvement became apparent in late 1999.[15]

Textiles and Clothing Sector Reform

The Association Agreement required the gradual elimination of all customs duties on textiles and clothing by the end of the sixth year through an annual one-seventh reduction in the tariff rate. This sector, which ranked second in terms of its share in total Polish industrial exports to the EU, was subject to the Multi-Fibre Arrangement ("MFA") restricting exports of textiles and clothing from developing countries to North America and Western Europe. While technically not a "developing country" under the MFA definition, the MFA restrictions had been applied to Poland. The Association Agreement did not address the non-tariff barrier coverage ratios for these products, which were the highest for all industrial products. Instead, the parties agreed to abolish quantitative restrictions over half of the period set in the Uruguay Round Agreement on Textiles and Clothing of 1994, which required all bilateral restrictions imposed under the MFA to be eliminated in four phases over a ten-year period, after which textiles and clothing would be completely integrated into the GATT.

Similar to the steel sector, the textiles and clothing sector was viewed as a "sunset" sector in most EU member states (with the exception of Italy), characterized by rising labor and capital costs and a declining share of domestic and foreign markets. Consequently, the sector was also highly sensitive politically, accounting for nine percent of total industrial employment in the EU. The sector was even more politically sensitive in Greece and Portugal, where it accounted for nearly one-third of manufacturing employment in 1995. During the recession in the EU in the early 1990s, the sector experienced greater hardship than did the manufacturing sector as a whole. Between 1989 and 1992, textiles production declined 4.7 percent and clothing production declined 6.4 percent, while investment declined 32 percent in textiles and 25 percent in clothing and

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

employment in both sectors declined 14 percent. Although the MFA restricted the amount of allowable intervention, these features sharpened the political focus and protective stance shown by EU officials toward the sector in the negotiation of the textiles-related provisions of the Association Agreement (Sheehy 1995).

Compared with Portugal, in 1992 the Polish textiles and clothing sector accounted for a lower proportion of total manufactured output (7.3 percent in Poland compared with 15.7 percent in Portugal) and a lower proportion of total employment (17.5 percent compared with 30.8 percent). Thus, labor productivity in the Polish sector was only 42 percent of the lower national average compared with the Portuguese 51 percent. Moreover, labor costs and the number of employees per firm were higher than in the Portuguese textiles and clothing sector.[16] Under central planning in Poland, the industry was given low priority and the non-market policy orientation of the sector resulted in a low level of investment and automation, low labor productivity and wages, and intensive use of unskilled labor. The Polish sector was also highly concentrated geographically, with one-third of the industry located in Lodz and a significant proportion in Lower Silesia (Dolny-Slask) and in the Northeast. Yet, at the start of the reforms the Government maintained high hopes for the sector. Speaking in 1991, Minister of Foreign Economic Relations Olechowski declared that the textiles sector, which then employed approximately 600,000 workers, had the potential to be the "engine of recovery" in Poland (Dunne 1991).[17]

The Government's first step in restructuring the textiles sector was to conduct an assessment of its economic viability. In January 1991, the Ministry of Industry and Trade hired the Boston Consulting Group to prepare a sectoral study and restructuring program for the sector. The study made several negative findings. First, the industry was characterized by an extreme concentration of open-end spinning capacity, with over 60 percent of ring spinning spindles located in plants of over 40,000 spindles and open-end spinning capacity concentrated in plants with over 10,000 rotors, which was not justified by the insignificant economies of scale (Benacek et al. 1995). Further, over 60 percent of the spinning machinery was more than 10 years old and the preparation and winding machinery was also outmoded.[18] Finally, the industry was characterized by low labor and

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

machine productivity and rising factor costs, including in the spinning, weaving, dyeing, finishing, and garment-making phases of production. The report recommended significant new investments in machinery and technology and, since Polish textiles exports were likely to be subject to MFA quotas, the development of a "mixed" quota allocation scheme based on past performance (used in Korea, Taiwan and Hong Kong) and auctions (used in Turkey and Hong Kong).[19]

In contrast to steel privatization, the Government's plan for textiles centered on extensive privatization as opposed to subsidies or other state assistance. Between 1990 and 1992, nine percent (96 enterprises) of all enterprises in the industry were privatized, with privatization in the sector slowing after 1992 owing to domestic political instability and the sector's deteriorating financial and economic situation. Among the 96 privatized enterprises, 13 (8 in textiles and 5 in clothing) were liquidated through asset sales or leasing to private owners, 30 (24 in textiles and 6 in clothing) were liquidated in bankruptcy-type proceedings, 33 (32 in textiles and 1 in clothing) participated in the mass privatization program and 20 (10 in textiles and 10 in clothing) were privatized by capital privatization (buy-outs).[20] Many enterprises had avoided restructuring during the radical liberalization period of 1990-91 by relying on inventories and sizeable foreign exchange bank accounts accumulated during the 1980s. After 1991 enterprises began to deplete their inventories and foreign exchange reserves. In order to survive, many enterprises began striving to improve product quality, management and marketing, and their performance generally improved during 1992-93. Nonetheless, the sector retained its "dualistic" nature, characterized by small and medium-sized firms selling on the domestic market and large firms selling on foreign markets.

Characterized by a lower degree of historical intervention in the form of subsidies and trade protection, the changes in the textiles sector were markedly different from the restructuring that took place in the steel sector. Investment in the textiles and clothing sector declined more on average between 1990 and 1992 than in the manufacturing industry as a whole, although it rose in the clothing sector by 63.5 percent in 1992 as a result of rapid privatization and new firm entry. Employment reductions in the state-owned portions of the

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

textiles and clothing sector between 1990 and 1992 were also larger than for the manufacturing sector as a whole. In particular, employment in the textiles sector fell 39 percent per year between 1990 and 1992, and 9 percent in 1993, while employment in the clothing sector fell 9 percent per year between 1990 and 1992 but increased 2.7 percent in 1993. However, when the private portion of the sector was included, the employment share of the textiles and clothing industry in total manufacturing actually rose from 17 percent in 1990 to 17.5 percent in 1992, suggesting a significant reallocation of labor from state-owned to private firms (Corado et al. 1995).

Taking into account the changes in production and employment between 1990 and 1993, the textiles and clothing sector remained a large sector of Polish industry. Although the share of the sector in domestic industrial output fell from 12 percent in 1989 to 5.8 percent in 1992, in 1993 the sector accounted for 8.5 percent of gross national production, 8 percent of total exports and 10 percent of the active labor force. Recognizing that most of the output of the sector did not meet the quality requirements of western markets and a large portion of the equipment needed upgrading or replacement, the Polish Agency for the Development of Industry devised four restructuring programs that were less interventionist than the initial steel sector program. The first program, "Polski Len" (Polish linen) covered the ten largest enterprises in the sector, accounting for 70 percent of productive capacity, and the second program, "Bielska Welna" (Bielska-Biala wool) covered nine enterprises. These two programs involved approximately US$ 300 million in financial assistance from the French-Polish Foundation and were considered successful, with output and productivity rising and employment falling in the enterprises concerned. The remaining two programs, "Lodzka Welna" (Lodz wool) and "Lodzka Bawelna" (Lodz cotton), covered thirty enterprises in the Lodz region and involved mostly technical aid for the restructuring of finance and production (Borzeda 1994). As these programs did not entail significant state aids or trade protection, the Government was able to maintain its pro-market policy stance and abide by the terms of the Association Agreement.

The Polish steel and textiles sectors provide a good comparative basis for examining how EU association strengthened the Government's hand in the face of domestic opposition. In terms of similari-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

ties, the EU deemed both sectors "sensitive" and both were economically and technologically distressed at the beginning of the transition. These sectors were politically charged relative to other industrial sectors and received deep scrutiny in the association negotiations. Unlike steel, the textiles sector was free of historically entrenched subsidies, and thus restructuring programs for the two sectors differed in terms of their reliance on state aids and temporary trade protection (see table below). Whereas the Government focused on privatization in the textiles sector (even where it entailed sizeable employment shifts), the Government had greater difficulty extricating itself from the steel sector. The Government's ability to maintain greater policy-making autonomy in the textiles sector was at least partially attributable to the lower degree of government intervention in the EU, particularly in light of the MFA. While the Government experienced greater difficulty resisting appeals for intervention in the steel sector, in both cases it preserved its policy-making autonomy relative to other domestic actors by reference to the EU.

COMPARISON OF RESTRUCTURING PROGRAMS FOR STEEL AND TEXTILES

	Steel	Textile/Clothing
Initial viability	Low	Low
Potential for market expansion	Considerable	Moderate
Need for capital outlays	Large	Large
Government intervention	High	Low
Percent of total employment in 1991	0.8%	4%
Percent of industrial employment in 1991	2.9%	14%

CONCLUSION

Despite the different approaches to restructuring the Polish steel and textiles industries, both sectors revealed several lessons as the Government faced rising opposition from domestic industrial groups. First, where domestic concerns were strong, as in the steel sector, EU

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

association did not serve as an immediately binding constraint on policy making, whereas financial resources and practical realities did. The ability of politically powerful domestic actors to force government leaders off their pro-market, pro-EU course did not appear to be a systemic feature of the domestic political landscape. Moreover, the contentious "interventionism" in the steel sector amounted at most to prolonging the status quo, while discussions with the EU elucidated a discernible policy frontier beyond which domestic industrial policy makers refused to stray. Second, in the face of domestic opposition, EU association allowed the Government to press ahead with painful reforms and shy away from state aids and distortionary export promotion policies. Looking to the future, the degree of required harmonization of Polish industrial policy with EU policy will grow during the accession process. As the EU deepens and more industrial policy issues gravitate onto the EU agenda, power redistribution in favor of the "executive"—government policy makers at the forefront of association and accession—relative to other domestic actors is sure to continue.

BIBLIOGRAPHY

Balcerowicz, L., *Socialism, Capitalism, Transformation* (New York: Central European University Press 1995).

Belka, M. and S. Krajewski, *Industrial Policy in Poland*, Paper prepared as part of ACE Project Number 94-0688-R, "The Role of Industrial Policy in the Transition in Central and Eastern Europe" (March 1996).

Belka, M., Krajewska, A. and Krajewski, S., "Stan I Perspektywy Przemyslu Tekstylnego w Regionie Lodzkim" [The State and Perspectives of the Textile Industry in the Lodz Region], *Gospodarka Narodowa*, vol. 2 (1993) pp. 34-38.

Benacek, V., Chemetilo, D., Dragan, N. and Petrov, A., "Economic Behavior, Adjustment and Performance of Producers in Transition," Paper of the 10th EEA Congress, Prague (1995).

Borzeda, A., "Le Tissu Industriel Polonais," *Le Courrier Des Pays de L'Est*, No. 387 (March 1994) pp. 43-73.

Boston Consulting Group, "Polish Textile and Clothing Industry Restructuring Programme: Executive Summary for the Government of Poland and the World Bank" (London: January 1991).

Caban, W. and Wysokinska, Z., "Polski Przemysl Wlokienniczy i Odziezowy w Procesie Transformacji Systemowej" [Polish Textiles and Clothing Industry in the Process of Systemic Transformational], *Gospodarka Narodowa*, vol. 2 (1993).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Corado, C, Benacek, V. and Caban, W., "Adjustment and Performance of the Textile and Clothing Industry in the Czech Republic, Poland and Portugal," CEPR Discussion Paper No. 1260 (London: CEPR November 1995).

Dunne, N., "US boost for Polish clothing," *Financial Times,* Sept. 27, 1991, p. 7.

"Government Urged to Revamp Steel, Other Sectors, Cut Tariffs on EU Steel," *BNA Eastern Europe Reporter*, vol. 8, January 23, 1998, p. 129.

Green, P.S., "Rules on Reform Won't Be Bent, EU Tells Poland," *International Herald Tribune*, October 19-20, 1996, p. 2.

Hutnicza Izba Przemyslowo-Handlowa, *Polski Przemysl Stalowy* [Polish Steel Industry] (1996).

Interview with Prime Minister Jan Bielecki, at the EBRD, in London, England, October 29, 1996.

ISI Emerging Markets Data, Business News from Poland, *Internet Securities* (statistics derived from CIHZ Foreign Trade Information Center) (March 6, 2000).

Jakobik, W., "Liberalization and De-Regulation of the Public Sector in the Transition from Plan to Market," *MOCT-MOST*, vol. 1 (January 1993) pp. 23-36.

Jaroszynska. A., "Restructuring Poland's Iron and Steel Industry," *Polish Foreign Trade* (May/June 1993).

Joskow, P.L., Schmalensee, R. and Tsukanova, N., "Competition Policy in Russia during and after Privatisation," *Brookings Papers on Economic Activity: Microeconomics* (1994) pp. 301-81.

Kolodko, G., *Poland 2000: The New Economic Strategy* (Warsaw: Poltext 1996).

Kornai, J., *The Road to a Free Economy: Shifting from a Socialist System: The Example of Hungary* (New York: W.W. Norton 1990).

Masi, A., "Steel," in Kassim, H. and Menon, A., *The European Union and National Industrial Policy* (London: Routledge 1996).

Ministry of Industry and Trade, "Miedzynarodowa Konkurncyjnosc Polskiego Przemyslu: Program Polityki Przemyslowej Na Lata 1995-1997" [International Competitiveness of Polish Industry: Industrial Policy Program for the Years 1995-1997] (Warsaw 1995).

Ministry of Industry and Trade, "Polityka Przemyslowa: Zalozenia: Program Realizacji w Latach 1993-1995" [Industrial Policy Foundations: Realization Program for the Years 1993-1995] (Warsaw: September 1993).

Moravcsik, A., "Preferences and Power in the European Community: A Liberal Intergovernmental Approach," *Journal of Common Market Studies*, vol. 31:4 (1993) pp. 473-524.

Moravcsik, A., "Why the European Community Strengthens the State: Domestic Politics and International Cooperation," Working Paper Series #52 (Cambridge, MA: Center for European Studies, Harvard University 1994).

OMRI Economic Digest, vol. 2 (44), October 31, 1996.

Oxford Analytica Daily Brief, October 24, 1996.

"Prawo i Gospodarka - Magazyn Finansowy," April, 1 2000, p. 11, in *ISI Emerging Markets Data, PNB—Economic Review*, April 11, 2000.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Sachs, J., "Building a Market Economy in Poland," *Scientific American* (March 1992) pp. 34-40.

Sheehy, J., "Economic Interpenetration Between the European Union and Central and Eastern Europe," in Dobrinsky, R. and Landesmann, M. (eds.), *Transforming Economies and European Integration* (Aldershot: Edward Elgar 1995).

Slay, B., "Evolution of Industrial Policy in Poland since 1989," *RFE/RL Research Report*, vol. 2 (2) (January 1993).

Socha, M. and Sztanderska, U., "Restructuring and Industrial Policy in Poland," *MOCT-MOST*, vol. 4 (2) (1994) pp. 71-106.

Tsoukalis, L., *The European Community and its Mediterranean Enlargement* (London: George Allen & Unwin 1991).

World Bank, *Poland: Country Economic Memorandum: Reform and Growth on the Road to the EU* (July 15, 1997).

World Bank, "Poland: Economic Transformation at a Crossroads" (March 16, 1992).

NOTES

1. Marek Belka served as economic advisor to the President and was Minister of Finance from January to October 1997.

2. In the case of Poland, the relevant "executive" in the realm of EU association encompassed not only the traditional executive but also EU-focused policy makers, including in the Committee for European Integration and special EU departments throughout the government bureaucracy.

3. See, e.g., T.C. Schelling, *Choice and Consequence* (Cambridge: Harvard University Press 1984).

4. Leszek Balcerowicz was Deputy Prime Minister and Minister of Finance in both the Mazowiecki and the Bielecki Governments (from September 1989 to December 1992).

5. The Solidarity Government's economic reform program was first outlined by Deputy Prime Minister Balcerowicz in September 1989 and elaborated in the Economic Transformation Program announced by the Council of Ministers in October 1989.

6. The same comment has also been attributed to Deputy Prime Minister Balcerowicz. See World Economy Research Institute, Warsaw, and International Centre for Economic Growth, San Francisco, *Transforming the Polish Economy* (Warsaw: Warsaw School of Economics, 1994) p. 115.

7. Included in enterprise expenditures were social expenses (such as employee housing), operating and maintenance costs, unrelated business expenses and wages.

8. The restructuring clause permits such measures to amount to up to 15% of the total imports of industrial products from the EU during the last year for which statistics are available.

9. Bielecki did not see the demands for temporary protection as reflective of problems with implementing the Association Agreement, but rather with carrying out painful reforms initiated in earlier years. For instance, restructuring of the petroleum refinery sector was initiated in 1991 but was never completed, leading the unrestructured sector to demand "temporary protection" (Interview with Bielecki 1996).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

10. The increases in tariffs did not exceed the relevant MFN rate or three-year time limitation. As noted by the World Bank, these "derogations from trade liberalization were not part of a comprehensive program of restructuring; rather, they resulted from pressures either to protect domestic producers or to attract foreign investors" (World Bank, 1997, p. 30).

11. The first industrial policy assumed that funding would come from foreign credit and investment. "Polityka Przemyslowa: Program Realizacja" (1993), p. 4. The second industrial policy assumed that funding from foreign capital (FDI), assistance and loans would amount to 4 billion zloty out of the total 14.7 billion zloty in 1994; 4.6 billion out of total 18.1 billion in 1995; 5.2 billion out of 19.8 billion in 1996; and 5.7 billion out of 15.8 billion in 1997 ("Miedzynarodowy Konkurencynosc," 1995).

12. These priorities were established on the basis of a sectoral study undertaken by a Canadian consortium comprised of Ernst & Young, Hatch and Stelco in December 1992.

13. As the program was never implemented, the promised financing was never raised.

14. In order to meet EU requirements, the Polish Council of Ministers on June 30, 1998, decided to reform the steel industry by cutting 50,000 jobs while maintaining current output levels. "Poland to Reform Coal, Steel Industries," *RFE/RL Newsline*, vol. 2, No. 124, Part II, 1 July 1998.

15. Polish steel mills suffered due to the economic crisis in Russia and the Far East, which halted the well-developing exports to this region. While the share of imports grew during 1996-1998, exports exceeded imports. The country maintained a trade deficit, however, given an average cost per ton of $270 for exports compared to $490 for imports.

16. In 1992, the average number of employees per firm in textiles and clothing was 443 and 211 respectively in Poland, and 133 and 74 respectively in Portugal. Corado et al. 1995.

17. Minister Olechowski made this remark shortly after the US had agreed to widen access for Polish textiles and had identified the sector as a key sector in the Polish economic transition. Minister Olechowski went on to argue that the Polish textile industry should be graduated from the MFA textile quota program because the industry no longer received subsidies and was completely open to trade.

18. The study also found that while Polish production covered most of domestic consumption requirements for man-made fibers, such as cellulosic fibres, polyester and nylon, imports were significant in natural fibers such as cotton, wool and acrylics.

19. Previously, the Polish government had allocated quotas to only three monopoly trading companies, Textilimpex, Confexim and Tricot. The mixed allocation system was advocated in order to safeguard existing trade relationships, in particular in relation to the EU, and to accommodate new entrants to the Polish export market.

20. State enterprises in the sector did not perform well during 1990-91, with declining production and employment, but improved their performance in 1992-93. In particular, textile production fell on average 15.7 percent between 1990 and 1992, which was above the average for the entire manufacturing sector. However, clothing production rose 14.7 percent between 1990 and 1992, and in 1993 production rose 13.4 percent in textiles and 9.7 percent in clothing. Further, new, smaller private firms became significant in the sector, with private sector sales reaching 27 percent of total textiles sales and 84.5 percent of total clothing sales in 1992 (Corado et al. 1995).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.