The Role of Foreign Direct Investment and Trade Policies in Poland’s Accession to the European Union

Bartłomiej Kaminski
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Bartłomiej Kaminski

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Foreword

The Poverty Reduction and Economic Management Unit in the World Bank’s Europe and Central Asia Region has been undertaking a series of analytical work on issues pertinent to the economies in the region. These issues include: transition issues; issues of economic integration pertinent for the Central and Eastern Europe countries which are candidates for accession to the European Union; poverty issues; and other economic management issues. The analytical work has been conducted by staff of the unit, other Bank staff as well as specialists outside of the Bank.

This technical paper series was launched to promote wider dissemination of this analytical work, with the objective of generating further discussions of the issues. The studies published in the series should therefore be viewed as work in progress.

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Director
Poverty Reduction and Economic Management Unit
Europe and Central Asia Region
The World Bank
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Executive Summary

The challenge of a pre-accession strategy is to identify policy measures that would improve allocative efficiency, reduce adjustment cost and strengthen Poland’s growth potential within the framework of integration into the EU. Ultimately, the prospects for a quick EU membership and, perhaps more importantly, the ability of the Polish economy to take full advantage of opportunities offered by membership, will depend on shifting to an institutional framework enhancing growth, competition, and economic efficiency. This chapter examines foreign trade institutional and policy issues in the broader context of investment regime and competition.

Poland has already made impressive progress in reintegrating into the world economy in general and the EU in particular. Its economy has become significantly more open than under central planning. Its foreign trade has undergone dramatic changes since 1989 in terms of geography (a shift toward the EU) and commodity composition (a switch towards manufactures). Foreign direct investment (FDI) inflows, after a slow start during the initial stages of transition, have begun to pick up since 1994 with positive impact on trade, technology and know-how.

Despite this impressive headway, much remains to be done to get the economy ready for a fast EU accession. From an economic perspective accession presupposes that a country is ready to complete the “four freedoms” which shape economic relations among EU members; free trade in goods, free capital flows, free trade in services, and free movement of people. Progress so far has been uneven in respect to each of these freedoms. Poland has yet to open its markets to duty-free industrial imports from the EU. The adjustment to competition from EU exporters lies ahead. Furthermore, mutual trade concessions do not cover agricultural products. Portugal and Spain have completed their respective transition periods, and are enjoying full access to both EU markets and the comprehensive Common Agricultural Policy (CAP) system, including export subsidies and guaranteed intervention prices as well as access to the agricultural structural funds. Therefore, Polish agricultural producers may face even more intense competition from the EU, which has already become a net exporter of farm products. As for other “freedoms,” Poland has yet to allow free trade in some services, while the EU is yet to demonstrate its willingness to accept the principle of free movement of people. The greatest progress in achieving the four freedoms has been in free capital movement; the extension of national treatment to foreign firms and full convertibility of Polish Zloty have removed major obstacles in this area. FDI combined with free trade would contribute to a faster catching-up in terms of Poland’s GDP.

The competitiveness of Polish firms in international markets—which is clearly the key to a sustainable export and economic growth performance—hinges critically on competition they encounter in their own markets. As the experience of central planning suggests, firms shielded from competitive markets are poor performers. In a market economy it is the responsibility of the state to remove restraints upon and barriers to competitive transacting both within and across national markets. The former is usually associated with competition policy, whereas the latter is in the domain of foreign trade policy. Both, if properly used, may contribute to a smoother adjustment to EU accession as they facilitate the efficient allocation of economic resources, contribute to improved international competitiveness, and thereby maximize national economic welfare. They may be complementary especially in nontradables and location
specific markets where foreign competition is inadequate. Last but not least, state actions often distort competition through state aid and establishing national champions.

Another factor potentially contributing to competition and modernization and therefore integration into the EU is foreign investment. With the dearth of firms having direct contacts with international markets and experience in marketing, foreign firms have already shown their potential in integrating this previously closed economy into the international economy. The unique importance of foreign firms arises from their potential to contribute to industrial restructuring, transfer of technology and managerial skills together with the demonstration effect that it may have on domestic firms, and build up an export sector. FDI through joint ventures with domestic firms has laid foundations for expansion in exports in Portugal and Spain, before and after their accession to the EU. With an appropriate mix of policies, FDI may ease Poland’s way into the EU.

The remainder of this paper is organized as follows. Section 2 briefly examines developments in foreign trade with a focus on identifying main challenges in the near future. Section 3 discusses market access for Polish products with an emphasis on nontariff trade barriers. Section 4 focuses on FDI, addressing questions related to its role in the adjustment to liberalization of trade with the EU and its impact on convergence to EU levels. Section 5 examines foreign trade institutions and policies in terms of their impact on resource allocation and economy-wide efficiency. Section 6 outlines the premises of a strategy that would simultaneously accomplish the twin goals of a fast accession and minimization of adjustment costs associated with the EU membership. The grounds and means of this strategy go beyond the trade sector proper. It also offers suggestions on how to redesign Poland’s institutions in order to avoid the trap of slow growth triggered by government-made distortions of foreign and domestic trade.

1. Foreign Trade Developments: Challenges Present and Future

Trade has been an important driving force of Poland’s economic recovery. During the transformational recession in 1990-92 the only bright spots were exports to the West. Their value surged by 46 percent in 1990 and subsequently sustained a double-digit expansion averaging 11 percent per year over 1990-95. This has provided a boost to recovery and expansion in imports. Imports have provided higher quality products, both for consumption and investment. This combined with competition from imports has stimulated local producers to improve their performance.

Poland has already made impressive gains in reintegrating into the world economy in general and the EU in particular. Its economy has become significantly more open than under central planning with foreign transactions accounting for around 40 percent of GDP. Its foreign trade has undergone dramatic changes since 1989. Geographically, it has shifted westward in line with economic considerations. The EU accounts for around two-thirds of Poland’s total trade—a dramatic increase from its level of 32 percent in 1989. By this measure alone, Poland is more integrated into the EU than several EU Member countries themselves! Germany has replaced the former Soviet Union as Poland’s largest trading partner; the share of the former increased from 15 percent in 1989 to 30 percent in 1996, while that of the latter fell from 20 percent to 12 percent over the same period. The commodity compo-
transition of Poland's exports in this direction has dramatically moved towards manufactures; its share increased from 47 percent in 1989 to 70 percent in 1996 (see table 1).

Yet, from a perspective of EU accession there are some developments that raise concerns whether this performance will be sustainable. Trade deficit, which seems to be of considerable concern to many policy makers in Poland, is not regarded here as a problem. Poland's trade deficits have been probably much lower than recorded in statistics. Opening of borders, the collapse of the Soviet Union and reunification of Germany have triggered significant increase in unrecorded trade. There are reasons to suspect that because of these unrecorded exports, the actual trade and current account balances might have been much lower. Poland's growing international reserves seem to confirm this observation (see chart 1).

**Table 1** Merchandise Trade in 1989-96

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<td><strong>Exports</strong></td>
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<tr>
<td>% to the EU</td>
<td>32</td>
<td>47</td>
<td>56</td>
<td>58</td>
<td>62</td>
<td>63</td>
<td>70</td>
<td>69</td>
</tr>
<tr>
<td>% to the former CMEA</td>
<td>41</td>
<td>27</td>
<td>15</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>17</td>
<td>19</td>
</tr>
<tr>
<td>share of manufactures* in exports to highly developed economies**</td>
<td>34</td>
<td>57</td>
<td>59</td>
<td>65</td>
<td>65</td>
<td>67</td>
<td>68</td>
<td>70</td>
</tr>
<tr>
<td><strong>Imports</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>% from the EU</td>
<td>46</td>
<td>50</td>
<td>53</td>
<td>57</td>
<td>58</td>
<td>64</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>share of capital goods in total imports (%)</td>
<td>13</td>
<td>12</td>
<td>12</td>
<td>14</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td></td>
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<tr>
<td>share of consumer goods (%)</td>
<td>32</td>
<td>37</td>
<td>37</td>
<td>38</td>
<td>36</td>
<td>35</td>
<td>34</td>
<td></td>
</tr>
</tbody>
</table>

* Manufactures include the following groups of Standard International Trade Classification—5 through 8 minus 68.
** Highly developed economies include EU and EFTA countries, Australia, Canada, Japan, New Zealand, and the United States.
Sources: Derived from the UN COMTRADE database. Estimates for 1996 based on National Bank of Poland data.

**Chart 1** Developments in the External Sector, 1990-95

Source: International Monetary Fund (1997).
Leaving aside the real size of deficits, there is nothing inherently wrong with a growing economy running a trade deficit insofar as it is financed by foreign investment. Polish investment and modernization needs cannot be met adequately with local savings and technology and know-how. While developments on the current account should be closely monitored for reasons discussed in Chapter 13, it should be mentioned that imports have been increasingly associated with the development of the supply side of the economy with intermediate and capital products accounting for more than two-thirds of Poland's total imports.

Neither do the fears often expressed by Polish economists and officials that relatively easy-to-activate sources of trade expansion have been depleted seem to be justified. It is true that during the first stages of the transition the expansion of exports to OECD (Organization for Economic Cooperation and Development) countries was fueled by the combination of a "regime shift" and catch-up dynamics. The fall in domestic demand as well as demand from former CMEA (Council of Mutual Economic Assistance) partners, and the removal of the disincentives to trade characteristic of central planning and earlier artificially suppressed levels of trade flows with the West, provided an initial boost. But these factors had ceased to account for Poland's export performance two or three years into the transition, and a good export performance has been sustained thereafter.

On the other hand, however, trade performance has become more sensitive to "fine-tuned" economic policies and relies more on new or restructured productive capacities. As for the former, the challenge facing policy makers is that strategy can be easily captured by protectionist domestic lobbying groups unless a right mix of institutions is in place. As for the latter, the task ahead is to attract increased inflows of FDI. Foreign firms have already played an important role—both directly (their share in exports and imports) and indirectly (through demonstration effect and services)—in Poland's foreign trade, and considering present investment commitments their role will significantly expand.

An oncoming challenge to Polish exporters comes from the EU lowering its external barriers to trade in line with its Uruguay Round commitments. The Round has produced deep tariff cuts and the outlawing of nontariff barriers—such as the Multifibre Arrangement (MFA) and voluntary export restraints. The average MFN (Most-Favored Nation) import-weighted applied tariff rate on industrial products in the EU will decrease by the year 2000 by 2.9 percent.\(^1\) Tariff reductions are particularly high for some Polish exports. For instance, the post-Uruguay Round applied rate on wood and furniture imports will be reduced by 5.5 percent and on metals by 3.3 percent. As a result, those Polish producers of industrial products who were able to compete in EU markets mainly thanks to preferential tariff margins (that is, the difference between a MFN rate and a tariff rate offered in the European Agreements (EA) will face difficulties in maintaining their market shares unless they raise efficiency.

Admittedly, the EU has an extensive web of preferential arrangements with many of its trading partners. Consequently, a number of preferred partners compete on the same footing in EU markets with products originating in Poland. These agreements, however, do not cover such formidable exporters as East Asian countries (including China), the United States, Canada, and exporters with the potential to compete in many similar products such as states that emerged from the dissolution of the Soviet Union. Exporters from these countries are subject to MFN treatment.

The intensity of competition from imports in Polish markets will significantly increase in the coming years with progressive reduction of tariffs stipulated by the EA (extended in 1995.
to industrial products not covered by reductions when the interim trade component of the
EA went into force in March 1992 and excluding automobiles). The share of industrial prod-
ucts in total industrial imports from the EU for which Poland eliminated duties was 33 per-
cent in 1992. These were mainly products not produced domestically. But beginning in 1995
Poland’s tariff concessions on industrial products went into effect; tariff rates on EU indus-
trial imports are slashed by 20 percent annually until 1999 when they will be zeroed on all
industrial products with the exception of motor vehicles.

The time frame of Polish tariff concessions under the EA has contributed to tariff escala-
tion; that is, tariff rates increased with the stage of processing, from 1992 to 1996. In order to
protect production at home, Poland initially “zeroed” tariff rates mainly on goods either not
produced domestically or on imported inputs used by domestic industry. The simple average
MFN rate on these products was 17 percent. Since many domestic producers use inputs sub-
ject to tariffs, the effective rate of protection on some finished goods significantly increased
and was substantially higher than the nominal tariff. But in 1996 these rates for industrial
products fell sharply—the average nominal rate from 11 percent in 1995 to 9 percent in 1996
and the effective rate from 15 to 12 percent over the same period.\(^2\) The complete elimination
of duties on finished industrial products from the EU will thus deprive domestic producers of
protection, which was significantly larger than implied by nominal rates.

Sharp reductions in the effective protection afforded to domestic producers are both a
challenge and an opportunity to boost efficiency. It remains to be seen how successful they
will be in adjusting to a more competitive environment. But domestic producers are likely
first to look to foreign trade policy makers to afford them an extra dose of protection. Policy
makers should not bow to these demands. Ultimately, how well Poland will tackle these chal-
lenges depends to a large extent on developments in policy realms. Because of deficiencies
in institutional structures underpinning the foreign trade policy process, devising sound
economic policies taking into account public rather than sectoral interests may be a formi-
dable challenge.

Overall, the policy challenge is to resist the temptation of resorting to administrative mea-
sures to offer protection to domestic producers or attract foreign direct investment to ad-
tress regional problems. The competitive pressures stemming from imports have led to fre-
quent withdrawals by the Polish government from commitments adopted under the EA (spe-
cifically, the use of safeguards) and to erecting various technical barriers to trade (see page
26). The introduction of domestic technical standards instead of simply following the EU
standards will result in a dramatic escalation of imports affected by non-tariff trade barriers
(NTBs). Seeking to address high unemployment rates in some regions, the government has
been introducing investment-related tax rebates and establishing special economic zones.\(^5\)
And, as will be argued later, the ad hoc management of foreign trade has not been removed
yet but has intensified.

Nonetheless the progress so far has been impressive. A recent World Bank study of foreign
trade performance of transition economies from the former Soviet Union and Central and
Eastern Europe puts Poland among top performers.\(^4\) With the initial asymmetries in the EA
(created by extension of the period before Poland provided a duty-free access to EU indus-
trial products) fading away and international competitive pressures rising as trade liberalizing
provisions of Uruguay Agreements come into effect, the challenge of adjustment in the late
1990’s is more demanding. It leaves little tolerance for economic policy blunders. Without a
sustained credible government commitment to opening of the economy to foreign investment and competition, Poland's capacity to handle new challenges and the ability to take advantage of EU membership will be greatly impaired.

2. Access to EU Markets: Nontariff Measures

The EA has set up an entirely new framework for EU-Polish mutual economic relationships. The EA differs substantially from other preferential agreements signed by the EU. It is different from EFTA-EU free trade agreements because it provides for enhanced access to agricultural markets similar to that granted to some developing countries in the Lomé Convention and the Mediterranean Agreements. By including provisions concerning convergence of Poland’s economic legislation to EU standards, the EA is more comprehensive than free trade arrangements. It stipulates a deep integration. Although it falls short of granting EU membership, it has placed Poland close to the top of the preferential pyramid of access to EU markets. (To keep issues in perspective, a caveat worth mentioning is that the EA’s significance stems not only from better access to EU markets but mainly from its impact on capital flows related to credibility of commitment to reforms “guaranteed” by the EA)

The trade liberalizing measures introduced by the EU after the collapse of central planning and fully developed in the EA were designed to support structural reforms in Poland. They have brought about improvement in market access and preferential treatment of Polish imports—though with some temporary variation, as the timing of and scope of concessions offered by the EU varied depending on products and the type of foreign trade policy instrument.

While the EA has given preferential status for Polish industrial exports (excluding initially some sensitive products), no similar far-reaching concessions were granted in terms of access to EU agricultural markets. The EA has removed some quantitative restrictions upon coming into effect of the Interim Trade Agreement in March 1992 and envisaged limited liberalization for the following product groups: meat, live animals, fruits, vegetables, and processed agricultural products. Trade in grain was not covered by the Agreements. Some agricultural exports were permitted to increase by 10 percent in each year over 1992-96 with tariffs and variable levies being gradually reduced. Overall, access to EU markets for agricultural products has remained restricted, but some imports have obtained preferential treatment.

With the importance of tariffs as instruments of protectionism dramatically falling in the EU as the result of post-cold-war trade negotiations under the GATT, the main instruments of protectionism have become nontariff barriers, including quantitative restrictions (Multifibre Agreement products, agricultural products), Voluntary Export Restraints (VERs), licenses, and import surveillance. EU imports of agricultural products, textiles, footwear, and motor vehicles are subject to such measures. Another very effective—in terms of suppressing imports—group of nontariff measures relates to the so-called trade remedy laws against “unfair” trade. Antidumping investigations and undertakings discourage importers from placing orders for products under investigation as well as for those falling into the same group because of the fear that antidumping duties will increase import cost.

While the EA is very specific on tariff measures, it does not embrace any special provisions that would limit the use of NTBs. It contains clauses securing gradual implementation of free trade in the products covered by the EA. According to the EA, neither new duties nor any
other charges with similar effects could be implemented once it was put into force. The same rule (the standstill principle) applies to quantitative restrictions with the exception of agricultural products (not initially included in the liberalization timetable) for which both tariffs and NTBs can be freely changed. Furthermore, in line with GATT rules, signatories may resort to various import-limiting measures. These include antidumping, safeguard clauses (when imports cause serious damage to domestic producers or disruptions in the economic situation of a country or a region), protection against balance of payments disturbances, and protective measures against disruptions in markets for agricultural products covered by the Interim Trade Agreement, as well as the introduction of bans and restrictions permitted under GATT rules.

While EU tariffs offer Poland a preferential treatment of its exports, in some sectors nontariff measures present significant barriers to market access. As an indication of their importance, Table 2 shows percentages of imports into the EU in 1993 from selected trading partners subject to nontariff barriers as these were applied in 1995. Narrow NTBs—as classified in the UNCTAD Database—include tariff quotas and seasonal tariffs; actions taken to increase tariffs under safeguards or in retaliation; extra customs surcharges; variable levies (including flexible import fees; global quotas, prohibitions or suspension of issuance of licenses; "voluntary" export restraints and products subject to Multifibre Agreements; price control mechanisms (minimum, reference prices, basic import prices, and trigger prices); "voluntary" export price restraint; and certification and local content requirement. In addition to measures covered in "narrow" NTBs, "all NTBs" cover such measures as specific taxes levied on imports, antidumping and countervailing (undertakings and duties alike), licensing, price controls on imports, health and safety regulations, and technical standards.

Two conclusions can be drawn from data in Table 2. First, among Visegrad countries Polish exports stand second to Hungary in terms of their sensitivity to NTBs in EU markets. The share of NTB-affected exports is also significantly larger than the average for developing

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Trade Coverage of Various Nontariff Measures Imposed in 1995 by the EU on Imports (Excluding Fuels in 1993)</th>
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<tbody>
<tr>
<td></td>
<td>World</td>
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<tr>
<td>All non-tariff barriers (NTBs)</td>
<td>16.5</td>
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<tr>
<td>Narrow NTBs (see text)</td>
<td>10.8</td>
</tr>
<tr>
<td>&quot;Voluntary&quot; Export Restraint</td>
<td>4.6</td>
</tr>
<tr>
<td>Variable Levies</td>
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<tr>
<td>Quantitative Restrictions</td>
<td>0.1</td>
</tr>
<tr>
<td>Price Controls Miscellaneous</td>
<td>0.6</td>
</tr>
<tr>
<td>Other Entry Charges</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Source: Derived from UNCTAD Database.
countries. Clearly, the EA has not deprived the EU of resort to its most favored import restricting tools—"voluntary" quotas in the name of safeguards and tariffs against dumping.

Second, the largest portion of Polish NTB-affected exports to the EU—accounting for 60 percent of these exports—stems from the "voluntary" export restrictions (VERs), whereby a Polish exporter agrees to limit exports in order to avoid the imposition of mandatory restrictions by the EU. The second type of measures affecting 12 percent of Polish NTB-ridden exports is "other entry charges," which include charges on product certification. Variable levies, designed to raise the price of an imported good to that of a corresponding domestic products accounted for another 8 percent. Other measures, accounting for the remaining 20 percent of these exports, included seasonal duties, antidumping and countervailing duties and investigations.

To what extent have the EU NTBs affected Polish exports? Vulnerability to NTBs depends on a country's export basket. Table 3 shows the share of individual Polish export products that encounter one or more nontariff barriers—(1995 measures are weighted in terms of 1993 exports). Individual products are identified here at the level of the importing countries' national tariff line. Foods and animal feeds is one of the most NTB-ridden product groups in EU markets. Two-thirds of Polish exports encounter nontariff barriers, mainly in the form of variable levies raising the market prices of imports close to the levels of corresponding domestic products. EU NTBs are applied to 56 percent of Polish oils and fats exports. The importance of NTB statistics is accented by related studies showing they often reflect very high levels of nominal protection with ad valorem equivalents of over 50 percent. Therefore, one may suspect that Polish agricultural exports might have been significantly larger in the absence of NTBs.

Table 3 Indices of Nontariff Trade Barriers Application to Polish Export Products in EU Markets

<table>
<thead>
<tr>
<th>Product Category</th>
<th>NTB Import Coverage %</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All NTBs</td>
<td>Voluntary</td>
</tr>
<tr>
<td>All Products (0 to 9)</td>
<td>100</td>
<td>9.4</td>
</tr>
<tr>
<td>All Product Excluding Fuels</td>
<td>92.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Foods (0+1+22+4)</td>
<td>10.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Live Animals (0)</td>
<td>10.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Beverages and Tobacco (1)</td>
<td>0.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Animal and Vegetable Oils and Fats (4)</td>
<td>3.9</td>
<td>0.1</td>
</tr>
<tr>
<td>Agricultural Materials (2-27-28)</td>
<td>11.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Ores and Metals (276-28+67+68)</td>
<td>3.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Iron and Steel (67)</td>
<td>66.8</td>
<td>29.4</td>
</tr>
<tr>
<td>All Manufactures (5 to 8+67+68)</td>
<td>5.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Chemicals (5)</td>
<td>0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Leather (61)</td>
<td>2.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Textiles (65)</td>
<td>16.8</td>
<td>97.7</td>
</tr>
<tr>
<td>Clothing (84)</td>
<td>0.8</td>
<td>97.0</td>
</tr>
<tr>
<td>footwear (85)</td>
<td>5.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>35.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Other manufactures</td>
<td>5.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: See Table 1.
As far as manufactures trade is concerned, NTB restrictions are largely concentrated in four sectors: leather and leather goods, textile yarn and fabrics, clothing, and footwear. These sectors accounted for 31 percent of manufactures exports and 20 percent of total exports to the EU. As with foodstuffs, the problem is that very high levels of nominal protection are usually associated with these nontariff measures. On the other hand, products subject to MFA quota agreements do not necessarily face market access problems. The evidence suggests that Polish exporters have been often unable to fill allowed quotas.

In short, the message that seems to emerge from tables 2 and 3 is that NTBs constitute an important impediment to Polish exports and, in specific sectors, they might have put a brake on trade expansion. Export expansion (especially of sensitive goods), price distortions, and implicit subsidies which have yet to be removed seem to have made Polish exporters an easy prey to EU vested interests. Between 1990 and 1995, the EU has launched 10 antidumping investigations against Polish imports. These were criticized in Poland because proceedings were often extended even to firms not exporting to the EU and, instead of using firms cost data, the EU antidumping authorities used the concept of the so-called constructed normal value including hefty profit rates.

Leaving aside the issue of “fairness” in treatment of some Polish exporters by the EU antidumping authorities, the crux of the matter is that the EA contains rules raising justifiable fears among Polish exporters of contingent protectionism. Unless competition and state aid regulations are fully implemented and vigilantly pursued, the GATT subsidy code will be used to assess distortions in market competition caused by monopolistic practices and state subsidies. The absence of these regulations (especially state aids) makes Polish exporters more vulnerable to various EU nontariff actions.

The problem could be at least partly remedied by amending the EA. Some analysts suggest replacing all existing antidumping and countervailing provisions of the EA with the Treaty of Rome articles devoted to competition. Indeed, the contingent protection provisions of the Treaty of Rome (Articles 91-93 and 115) are economically sounder than the EA. Article 91 (2) allows countries to treat dumping by reexporting the allegedly dumped goods to the country of origin, thus providing a powerful disincentive on spurious actions designed to suppress imports. This in turn would release powerful forces towards market unification.

3. Foreign Direct Investment and Convergence: The Potential to be Explored

(Note: This section draws heavily on Wes (1996)) FDI inflows (net of repatriation to Poland) increased from about $90 million in 1990 to around $2.5 billion in 1995—FDI doubled in 1995, and its value is expected to double again in 1996. Measured against GDP, its share rose from negligible levels in 1990 to 1.8 percent in 1992, and 2.2 percent in 1995. Its current level in terms of the share of GDP is three times higher than the pre-accession shares in Portugal and Spain—the two most recent members of the EU—though admittedly the flows of FDI in the world economy have dramatically expanded over the past decade. FDI has had a more profound impact on Poland’s ability to reintegrate into the world economy than these relatively low numbers alone might suggest.
Impacts of Foreign Direct Investment

Despite a short time that has elapsed since FDI began flowing into Poland, there are signs that it has already enhanced Poland's export capabilities. Foreign firms are much more foreign-trade oriented than domestic firms, thus making a relatively larger contribution to reintegration of Poland into the world economy—especially into the EU as 78 percent of their exports and 75 percent of their imports were with the EU in 1995. Although firms with foreign capital generated 12.4 percent of total income and accounted for 7 percent of total employment, their shares in exports and imports were 34.4 and 42.1 percent respectively. Among the one hundred largest Polish exporters to the EU, accounting for 38 percent of total EU-directed exports, there were 25 firms with foreign capital; 13 of these firms were among the top 50 on this list. Considering that the ranking is biased in favor of large exporters of heavy chemicals, steel products, and exporters of natural resources (copper, coal, sulfur), which are yet to be privatized and opened to foreign investors, this share is impressive.

Indirect effects related to restructuring, productivity spillovers, and foreign firms' contribution to the development of the export infrastructure are more difficult to capture. With many service sectors still closed to FDI, its impact on the export infrastructure so far has been limited. Some indirect measures suggest, however, foreign firms' rapidly expanding role in industrial restructuring: consider that the share of foreign companies in total investment outlays increased from around 20 percent in 1994 to 25 percent in 1995.

FDI is a powerful vehicle for transfers of technology, best practices in management, and increasingly, for integrating domestic production capacities into global networks of production and distribution. There is evidence that FDI has contributed to the growth in linkages between Polish firms and their counterparts in the EU by integrating some of them into a global network of production and marketing. This can be observed through increases in intra-industry trade. This trade allows realization of economies of scale thanks to greater product specialization and differentiation. The share of intra-industry trade involving the EU, as measured by the Grubbel-Lloyd index (the difference between unity and the quotient of the absolute difference between exports and imports of a given sector and the total of imports and exports for this sector), increased by around one-third over 1989-95 from 0.22 to 0.28. The advantage of intra-industry trade over inter-industry trade is that it is less vulnerable to swings in the domestic business cycle, thus assuring a higher degree of stability in country's export earnings.

Another important advantage of intra-industry trade is that, in contrast to inter-industry trade, it leads to lesser inequalities in regional development and income distribution. Conventional comparative advantage brings about inter-industry specialization, as it operates on groups of products rather than within them. The force driving two-way trade in similar differentiated products is economies of scale associated with supplying a larger market, whereas the reason a country cannot produce a complete range of these products relates to fixed costs of production. In consequence, countries with similar factor endowments find a reason to trade with each other. This trade does not involve relocation of whole industries, since both factors of production, labor and capital, gain from it. Consequently, specialization in differentiated products associated with intra-industry trade poses fewer adjustment problems than inter-industry trade.
FDI has thus contributed to dispelling fears that engagement in a preferential trading arrangement with the highly developed EU might lead to a catastrophic relocation of Poland's industries. These fears may have been justified to some extent by findings of the new trade theory and economic geography models. While the new trade theory suggests the overall benefits are likely to be significantly larger than those suggested by traditional approaches, economic geography models allow for the possibility that gains, especially during the early stages of integration, will be distributed in favor of a more developed partner—namely, the EU. Firms operating under the conditions of imperfect competition and economies of scale, such as in increasing returns-to-scale industries, tend to cluster together, drawn by the availability of supplies due to the higher concentration of demand, which occurs in a more developed country.

This "agglomeration economies" effect may be further exacerbated by the hub-and-spoke arrangements with firms in a spoke country (such as Poland). These firms are likely to have larger costs for two reasons: they face higher barriers than hub firms when importing inputs from the other spokes, and they tend to be penalized by lower demand from other spokes due to trade barriers. The Central European Free Trade Area (CEFTA) has somewhat weakened the hub-and-spoke effect, whereas good access to EU markets, low wages, and investment by multinational corporations thanks to their global marketing networks have prevented relocation of increasing returns-to-scale industries and generated dynamic growth effects.

FDI is often accused of having an adverse effect on the balance of payments. Indeed, exports by foreign firms were lower than their imports, and they accounted for 71 percent of Poland's trade deficit in 1995. But this is hardly surprising. Imports of capital goods associated with FDI always increase the current account deficit. But their contribution to the current account deficit seems to have been more than offset by the positive impact of FDI inflows on the capital account and induced export earnings.

The Challenge of Maintaining Momentum

Overall FDI has eased the pain of transition and contributed to the achieved progress in reintegration into the European economy. But several concerns loom on the horizon, as some pull factors that were responsible for attracting FDI have been losing their importance. First, during the initial phases of transition some FDIs have been attracted by "black holes" inherited from central planning such as shortages of higher quality consumer goods, both durables and nondurables. They have aimed primarily, albeit not exclusively, at such products as processed food, beverages (especially beer and soft drinks), tobacco, soap and publishing industries.

But the initial excess demand gap has probably reached its saturation levels, and FDI inflows may dry up. There are two caveats, however. Opening of sectors to FDI where privatization was delayed may spur new inflows, and recent market successes of high quality "no-name" brands may suggest new sources of FDI inflows. Although Polish consumers have limited spending power, they have so far been more brand conscious than their Western counterparts. This has benefited many foreign investors. However, there are some signs that consumers are already becoming more brand-cynical, and some international manufacturers
are now beginning to introduce high quality local brands or to improve existing ones. It will lead to a greater involvement of local companies in FDI.

Second, the continued attractiveness of Poland as a location for FDI is closely linked to trends in labor costs and flexibility of labor markets. These hinge critically on the relationship between labor productivity and wage movements as well as on the pace of appreciation of the Polish Zloty. The latter is also shaped by foreign investment inflows, as their increases contribute to upward movements in the real exchange rate. Wage restraint was of great importance to the successful economic development of Japan and the Asian tigers. It is difficult to predict whether this will be also the case in Poland. But the Polish hidden advantage may be that the wage differential between Poland and the EU is particularly large for highly skilled labor.

Third, FDI has been most common not only in sectors with low production costs due to cheap labor but especially those that are considered 'sensitive' under the Europe Agreement. In fact, outward processing (OPT) as a share of Polish exports to the EU has considerably increased in the textiles and apparel industries, where it is estimated that OPT amounts to 70-80 percent of total exports. OPT seems to have been largely triggered by the provisions of the EA concerning tariffs and restrictive rules of origin. The EU tariffs on reimports of OPT textiles were abolished the day that the interim agreement went into force. However, EU custom duties on 'ordinary' textile imports were covered by the MFA. Hence, they were subject to both tariffs and quotas. Since none of these barriers applied to OPT—especially textiles subject to the trade restrictive MFA—many EU companies transferred production to Poland. This motive may disappear as labor costs go up and trade restrictions in the EU go down.

Fourth, some foreign investors have been lured by government subsidies. These were in the form of either suppressing import competition through protectionist measures or offering tax-breaks in Special Economic Zones. These strategies are counterproductive for the reasons discussed in box 1. There has been a positive correlation between FDI-intensive sectors and the level of tariff protection. These sectors had in 1992 average tariff rates on imports 66 percent higher than that in manufacturing as a whole.17 In fact, the list of sectors with the largest FDI commitments (cars, drinks and tobacco) corresponds fully with that of sectors favored by tariff reschedulings.

The use of Special Economic Zones to attract FDI through tax concessions is of more recent vintage; the Katowice Special Economic Zone was established in July 1996 as part of an agreement with General Motors.18 But this type of a measure is similarly harmful. It introduces a bargaining component into the relationship between government and foreign investors, suggesting that the rules of the involvement of foreign firms are up for negotiation. The increased bureaucratization of entry usually discourages high-quality investment inflows, raising serious doubts as to credibility of government commitment to liberal economic policies.

These caveats notwithstanding, Poland's potential as a recipient of FDI is yet to be tapped by foreign investors. Until 1994 the annual changes in net FDI inflows per capita in Poland were very similar to these in Slovakia (see chart 2). In 1995 Poland moved ahead in terms of total net inflows per capita for the 1990-95 period. But both the Czech Republic and Hungary have attracted considerably larger flows of FDI than Poland on a per capita basis. The differences in distance to EU markets or in infrastructure do not seem to account for it, since these are negligible. Three factors seem to account for Poland's subpar performance. First,
Box 1 Should Government Offer Incentives to Attract Foreign Direct Investment?

On theoretical grounds, a common justification for offering government incentives is that FDI generates benefits to the home country that are ignored by the investor. If the social benefits of FDI to the host country outweigh the private benefits to the investor, government intervention may welfare-improving. The benefits generated by the investment then outweigh the cost to the public of paying for the investment incentives. However, several caveats apply. First, even if there is a justified argument for government intervention, trade policy is a wrong policy instrument. A direct production subsidy would have the same effect as far as the foreign investor is concerned. But it would involve lower welfare losses, since a production subsidy only distorts the production side of the economy, leaving the price to consumers unaffected. In contrast, any trade policy instrument distorts both production and consumption, leading to larger welfare losses.

Second, offering special incentives to foreign investors induces them to deceive the government. For instance, a foreign investor will try to attain special treatment whether or not it is needed for the investment to be realized. Furthermore, the government may find itself seated with inefficient firms supported by "unearned" rents which muddy the social and political atmosphere—a rather unwelcome outcome in a country still saddled with inefficient white elephants inherited from central planning. In consequence, these negative welfare effects likely outweigh any positive effects associated with the investment.

Empirical evidence offers support to this conclusion. Taking into account the current trends in the global economy and the available evidence of responses to them, there is no defensible argument in favor of this strategy of attracting FDI. With new communication technologies and more competitive international markets, the role of FDI in development has undergone a profound change; rather than exploiting local, protected markets through import-substitution, FDI disperses its activities across countries linking "borderless" subsidiaries in global networks of production and marketing. In this context, luring investment through offering import protection is counterproductive. Attracting FDI by a liberal trade and investment-friendly environment is the only efficient tool for developing new industries and restructuring the existing sectors.

East Asian economies have attracted huge inflows of FDI thanks to sound macro-economic policies and economic openness. A survey of 175 Japanese investors identified, among others, the following disincentives to investment: local ownership and use of local input requirement; restrictions on repatriation of profits; and high tariffs on parts and components. Tax concessions were described as unimportant.

the perception among foreign investors of the inherently unstable political situation following the implementation of the stabilization cum transformation program in 1990. It does not matter that the perception was unfounded, as subsequent elections and a peaceful transfer of power have demonstrated. Second, until the London Club debt restructuring agreement was concluded in late 1994, many potential investors continued to have doubts about Poland's ability to sustain macroeconomic stability. The third factor—clearly much more important—relates to differences in economic policies. In Czech Republic and Hungary privatization has not only proceeded faster but it has been more extensive in terms of sectoral coverage. This points to the significant potential to increase FDI provided that the right mix of policies is implemented.

In Poland, service sectors—whose privatization in Hungary has been done mostly by foreign investors—have practically been closed to external competition. While in accordance with the EA the general right of establishment and national treatment has been granted for most activities, Poland insisted that such a right be granted for some activities, especially in
the service sector, only after a transition period. Although Poland has retained discretion over shortening these transitions, so far no decision has been made to do so. As a result, a whole array of services—such as telecommunications, financial intermediation, and port services—which are crucial for a country to be able to exploit opportunities offered by the global economy have lagged behind in terms of FDI and quality.

Once these sectors are open to foreign penetration, they will attract FDI to other sectors where continued inflow of investment would contribute to the development of forward (cost) and backward (demand) linkages between firms, as well as to the development of export infrastructure. Because of Poland’s size and favorable location, this would open an opportunity to tap economies of agglomeration and attract investment in increasing-returns-to-scale industries. Firms have an incentive to locate closely to each other in order to take advantage of agglomeration economies.

In addition, Poland’s strategic location between Western Europe and the New Independent States (NIS) of the former Soviet Union makes it a very attractive base from which to serve the regional market. Further reforms in the NIS will increase market-oriented investments in Poland. In order to maximize the gains from regional market expansion, further trade liberalization within Central and Eastern Europe and the NIS is of the greatest importance. Deeper integration within CEFTA in terms of common competition policy, rules on state aids, or removing technical barriers would attract FDI to the region, including Poland. Combined with liberalization in trade with the NIS, this would effectively increase the market size that foreign investors in Poland face.

The momentum in FDI inflows now works in favor of Poland. In the first quarter of 1996 alone FDI of $1.1 billion amounted to 40 percent of total 1995 inflows of $2.5 billion. With privatization of many sectors still unfinished, Poland’s capacity to absorb FDI is probably
four times larger than its value in 1995. The projections of FDI in 1996 put its value at $5 billion. With accession one would expect at least doubling of FDI, as it occurred in Spain but under a less friendly global environment for FDI in the 1980s. The task now, however, is to assure a continued expansion of these flows. Improving the environment for private business activity, both foreign and domestic, is a necessary condition to achieve this goal.

4. Foreign Trade Regime: Growing Complexity and Creeping Interventionism

Dismantling of the state monopoly over foreign trade began well before the collapse of central planning. Yet 1990 was a turning point on three important counts. With the introduction of the 1990 stabilization-cum-transformation program exchange rates were unified, access to foreign trade activity fully liberalized on both import and export side, and tariffs applied uniformly to all imports. Tariffs became the major factor shaping access to Poland's markets. The new customs law, however, has not closed all loopholes allowing imposition of new tariffs, quantitative restrictions, and various surcharges. Despite the suspension of tariffs for six months in June 1990, the policy makers were quick to explore opportunities for ad hoc management, as exemplified by extra taxes on imported consumer electronics.

Contrary to predictions, liberalization of foreign trade did not destroy domestic producers as it was protected by a heavily undervalued Zloty and other idiosyncrasies of the collapse of central planning. Despite the abrupt liberalization, Poland recorded in 1990 a sharp decline in imports accompanied by the surge in exports to OECD countries. Yet, following a strong appreciation of the Polish Zloty in 1991, tariffs were reintroduced and the foreign trade management has become increasingly politicized.

Poland's foreign trade institutions and policies distort allocation of resources, reduce contestability of domestic markets and protect inefficient firms. These are supported by "unearned rents" which muddy the social and political atmosphere. The major sources of distortions include ad hoc management by the state of quotas and tariff exemptions (procedural protection), nontariff measures including various technical barriers to trade, the use of safeguards, and structure of tariffs. Their combination introduces an element of unpredictable change in Poland's import regime.

The potentially most damaging impact on the transition process is management of quotas and tariff exemptions, for one major reason: it impedes the transformation in the role of the state from that of an owner and operator to that of a policy maker and facilitator of private economic activity.

Nontariff Measures

Table 4 contains data on frequency and import coverage of various NTBs (as defined in the UNCTAD database) as well as identifying major sectors of the economy in which they are concentrated. The frequency ratio of 1.6 percent—indicating the proportion of national tariff lines affected by a NTB no matter whether a particular product is imported—is very low in comparison to the EU's 14.2 percent. The NTB coverage ratio, that is, the percentage of Poland's imports subject to NTBs (in other words, an import-weighted frequency ratio), amounts to 3 percent. Again, by the standards of highly developed countries, the NTB cover-
Table 4 Persuasiveness of Nontariff Trade Barriers and their Coverage by Major Product Groups

<table>
<thead>
<tr>
<th>Product Group</th>
<th>NTB Coverage</th>
<th>Frequency</th>
<th>Value of Imports Affected by NTBs in 1995</th>
<th>Value of Imports Affected by NTBs</th>
<th>Share of the EU in NTB-Affected Imports</th>
<th>Share of the EU in Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Products (1 to 8)</td>
<td>3.21</td>
<td>1.60</td>
<td>998</td>
<td>28,902</td>
<td>64.8</td>
<td>82.3</td>
</tr>
<tr>
<td>All Products excluding fuels (1 to 8-3)</td>
<td>3.53</td>
<td>1.61</td>
<td>926</td>
<td>26,237</td>
<td>69.1</td>
<td>82.5</td>
</tr>
<tr>
<td>Foods (0+1+22+4)</td>
<td>4.90</td>
<td>12.79</td>
<td>136</td>
<td>2,776</td>
<td>46.8</td>
<td>74.3</td>
</tr>
<tr>
<td>Live Animals (0)</td>
<td>3.36</td>
<td>8.72</td>
<td>78</td>
<td>2,334</td>
<td>46.3</td>
<td>84.6</td>
</tr>
<tr>
<td>Beverages and Tobacco (1)</td>
<td>26.56</td>
<td>38.35</td>
<td>58</td>
<td>217</td>
<td>41.5</td>
<td>84.6</td>
</tr>
<tr>
<td>Manufactures (5 to 8-67-68)</td>
<td>3.82</td>
<td>0.82</td>
<td>790</td>
<td>20,669</td>
<td>74.9</td>
<td>83.9</td>
</tr>
<tr>
<td>Chemicals (3)</td>
<td>0.49</td>
<td>0.18</td>
<td>21</td>
<td>4,298</td>
<td>69.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Motor vehicles (781)</td>
<td>99.97</td>
<td>98.44</td>
<td>486</td>
<td>466</td>
<td>87.5</td>
<td>87.3</td>
</tr>
<tr>
<td>Other manufactures</td>
<td>2.32</td>
<td>0.50</td>
<td>303</td>
<td>13,074</td>
<td>75.5</td>
<td>84.5</td>
</tr>
</tbody>
</table>

Source: own calculations based on Central Statistical Office foreign trade data and the UNCTAD data base on NTBs.

...age ratio is very low (for the EU it amounted to 16.5 percent). Not only are NTBs less prevalent in Poland than in the highly industrialized countries, but also some types of NTBs are much less diversified. Poland relies mainly on quantitative restrictions with 84 percent of NTB-affected imports controlled by quotas and prohibitions. Also, the share of the EU’s NTB-affected exports in Polish NTB-ridden imports tends to be significantly higher than that in total imports, indicating larger “vulnerability” of EU exporters than the average. The major culprit is cars, accounting for more than 50 percent of NTB-affected imports.

The NTB-ridden product groups in Poland are beverages and tobacco, live animals for meat, and motor vehicles. NTBs on agricultural products testify to the political power of the agricultural lobby, whereas those on cars illustrate the misuse of trade policies as a way to attract FDI. In 1995 these sectors accounted for 83 percent of all imports affected by NTBs. Almost all other sectors—even those with a significant share of state-owned enterprises—are relatively free of NTBs, although with some caveats (see pages 28 and 29).

However, the picture of a very limited administrative intervention into trade flows that can be derived from the data in table 4 is misleading. First, NTBs as defined in the UNCTAD data base ignore domestic measures reducing access to markets. They pertain only to border measures. Former centrally planned economies, including Poland until accession to OECD, maintained a dual legal system with different rules applicable to domestic trade and foreign trade. This has created an opportunity to rely on non-border protection.

Second, although the use of traditional nontariff measures so far has been limited, the temptation to micromanage selected areas of foreign trade has been less and less resisted. The focus of foreign trade policy has been rather on finding ways of maintaining, if not increasing, protection in face of falling border protection as required by international treaties rather than on finding ways to increase the scope of free trade. Poland is about to introduce a new antidumping law despite the fact that its Customs Law already has provisions to deal with antidumping and the authorities can easily resort to other safeguard instruments. Considering also that with the EU accession the locus of foreign trade policy making will...
move to Brussels, this initiative seems to be redundant and amounts to a waste of bureaucratic resources. The case for antidumping is political not economic (see box 2). The discretionary use of tariff quotas and exemptions suggests also a significant extent of administrative ad hoc management of imports (see page 28). This state activity is not captured in the UNCTAD Database.

Third, two cases (whose overall negative impact so far has been more in politics than in economics) provide an illustration of actions marking the shift to a greater use of instruments of non-border protection as substitutes for tariffs. (Needless to say these should not be part of a well-designed pre-accession strategy.) The first concerns technical standards. Instead of adopting EU product standards, safety regulations and certification procedures, Poland has imposed its own rules covering over 1,400 product categories. Products listed in the Certification Law account for a large percentage of all products consumed and produced in Poland. It covers steel products, nonferrous products, capital equipment, precision products,

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**Box 2 Why States Should Refrain from Adopting Antidumping Legislation**

Antidumping measures are allowed under GATT 1994, but they are optional, not obligatory. There are several powerful reasons why one should refrain from adopting antidumping legislation (such as laws designed to prevent imports at a price below the production cost).

The existence of an antidumping legislation increases the leverage of protectionist interests over the government. It breeds lobbying, corruption, rent-seeking, and diverts scarce entrepreneurial talent into the political process. It creates temptation to resort to antidumping to cover whatever sort of import restrictions seems politically necessary. In brief, it increases the chances of a capture of foreign trade policy making by sectoral interests, as the “dumping” case can always be demonstrated.

The standards of antidumping do not make economic sense; they do not guide government to deciding where an import restriction would harm or serve the national economic interest. The injury guidelines for import restrictions do not take into account the higher productivity of resources in other sectors, and the benefits to users of imports and domestic goods that compete with imports.

Antidumping rules provide for an easy exit from a liberal foreign trade regime. They reduce import competition in domestic markets and raise prices as a mere opening of the investigation causes imports to fall and prices paid by users to increase; and they rarely, if at all, address cases which present a real threat to competition. According to a conservative OECD estimate around 90 percent of antidumping actions undertaken by the European Union and United States were not in response to a threat to competition (see Finger 1995). In other words, these cases would not be caught under anti-trust standards.

Thus, while it is tempting to introduce antidumping legislation, it is a bad idea from the viewpoint of national economic interests. The alternative—a safeguard option—is a better approach to follow but it should be administered properly.

In case of serious injury caused by imports, GATT Article XIX allows for safeguard actions. If protectionist measures are necessary to prevent injury to domestic producers, they should be price-based (that is, expressed in terms of tariffs), precisely defined, temporary, nondiscriminatory and introduced after appropriate procedures consistent with WTO rules are followed, and taking into account the costs to consumers and users. Thus, there is no need to resort to antidumping laws.

The Agency responsible for conducting the injury investigation should comprehensively address costs to users of investigated imports and benefits to an industry seeking contemporary protection.
transport equipment, electronic products, engineering products, chemicals, construction materials, glass and ceramic products, wood and paper products, textiles and clothing, and leather products. The refusal to accept foreign firms' self-certification of conformance to domestic standards forces producers to undertake lengthy testing procedures in designated units. The (incomplete) agreement, only with the EU, in which Polish authorities would have agreed to accept the EU safety certification (the CE mark) for some products would exacerbate the reverse discrimination that already exists because of preferential (or discriminatory) trading agreements.

Due to pressures from major trading partners (including CEFTA), the implementation of the law was temporarily suspended. Although this falls short of revoking it, this incident points to a much larger problem of deficiencies inherent in the framework of economic policymaking in Poland. However, if this law is implemented and fully enforced, it will erect a formidable nontariff barrier to trade, as these products account for a very large share Poland’s manufactures imports.

The second case, which has much less weight, relates to the recently introduced requirements concerning weed content of grain imported into Poland. The problem is that they are more restrictive than those followed by major grain trading countries including EU Members. Although these are allowed under the WTO phytosanitary standards, their sole purpose is to curb imports. This action raises doubts as to Poland’s commitment to liberal economic policies with potentially negative impacts on foreign investors’ perceptions of business climate in Poland.

Quotas and Tariff Exemptions

Barriers to trade stemming from ad hoc administrative action tend to be more pervasive in countries with the legacy of central planning. Inherited bureaucratic structures have less respect for property rights and display more energy in the effort to maintain direct influence over economic activity. Poland is not an exception. The potential welfare losses due to increased uncertainty in business activity and increased dependence of many firms on state’s pork-barrel policies are difficult to capture quantitatively but they are quite significant.

Tariff exemptions (or literally in Polish duty suspensions) or quotas are granted by the government usually for a limited time. They cover a wide range of products (in 1996 around 4,000 categories) including among others pesticides, electronic components, lighting equipment, building materials, and medical equipment. The logic behind quotas and tariff exemption has varied. Some have been justified in terms of remedying the alleged deficiencies in the existing tariff structure resulting in its de-escalation as tariffs are slashed according to preferential trading agreements. An example is tariff suspension on imports of computer components. With a tariff rate of 10.4 percent on electronic components and a zero tariff rate on computer imports from the EU, Polish firms assembling computers have a significant cost disadvantage. Since tariff suspension is only temporary, it unnecessarily creates a patronage relationship between government and affected firms. Needless to say, there are better remedies for ill-designed tariffs than tariff exemptions. For instance, one might consider either zeroing them or bringing them down to the EU levels.

Others exemptions were granted to address emergency input needs of specific industrial sectors undergoing restructuring. Telecommunication industry has obtained permission to import duty-free products and capital goods. Similarly, in response to perceived needs of
other sectors of the economy with political clout, duties on various imports are suspended for a specified period of time (for example, tractors for the first six months of 1996).

For other products exemptions were given to deal with inflationary consequences of economic policies. Unintended consequences of domestic policies resulting in the growth in domestic prices of some products (usually agricultural products but also some chemicals) above world prices, or discrepancies between controlled domestic prices and world prices leading to shortages (of oil, for instance), provided justifications for state interventions.

Another set of exemptions was introduced as a way to provide subsidies to the government. Quotas were introduced on fire engines, medical equipment, and environmental protection equipment. But these were made available only to central government agencies and local governments.

In all, the process of managing tariff exemptions and quotas lacks transparency and is devoid of clearly defined criteria for granting tariff exemptions. The process causes uncertainty and increases the risk of exemptions being controlled by rent-seeking private interest. Indeed, there is evidence that they are often granted in response to pressures exerted by domestic lobbies and foreign investors. The exemption of lightning equipment from duties, for instance, coincided with the decision of Philips to invest in Poland. Last but not least, it offers the administration a proven way to regain some of its discretion power lost as a result of the collapse of central planning.

Subsidies and Countervailing Measures

Fulfilling its obligations under the WTO Agreement on Subsidies and Countervailing Measures, Poland has notified the Committee about five programs falling under its purview: investment-related tax rebates; special economic zones; interest subsidies on bank loans; the credit guarantee scheme; and export insurance government guarantees. These programs are of recent vintage, initiated in 1994 and 1995 (see box 3). No time framework has been set to phase out these programs as stipulated by the EA’s Article 29:3, which requires bringing such programs in line with WTO rules within a period of seven years from the date of coming into force of the WTO agreement.

All these programs are designed to promote exports and provide subsidies to exporters, albeit under different guises. Granting of investment rebates is linked directly to export performance; a firm can deduct investment expenses from pre-tax income only if export earnings exceed 50 percent of income or are greater than ECU 8 million. Interest subsidies for contract financing are also linked to export performance. Firms operating within a Special Economic Zone (SEZ) called Euro-Park Mielec are exempted from corporate income tax up to an amount equivalent to half of their export earnings. However, there is no explicit subsidy in the export insurance guarantee program unless foreign importers systematically default on their obligations (exporters may obtain state guarantees of up to 85 percent of the contract against commercial risk and up to 90 percent against noncommercial risk). But this apparently has not been the case.

The scope of these programs seems to be rather limited. Poland’s notification to the WTO Committee on Subsidies and Countervailing Measures does not provide information on export activity under SEZ or tax rebates granted under the investment-related tax program. But if activities under remaining programs give any indication, they do not have a prominent impact on competitiveness of Polish exporters. The credit guarantees in 1995
Box 3 Subsidies and Countervailing Measures

1. Investment-related tax rebates
   implementation date: 10 February 1994
   objective: to encourage investment in export-oriented activity
   eligibility: taxpayers undertaking economic activity or special types of agricultural production
   financial instruments: if export earnings are larger than 50% of the total revenues or greater than ECU 8 million, the investment expenses can be deducted from pre-tax income.
   time schedule of conforming to Article 3 (7 years): no explicit time limit set

2. Special economic zones—Euro-Park Mielec managed by the Agency for Industrial Development
   implementation date: 23 December 1994
   objective: to encourage economic restructuring and promote local development
   eligibility: the application by the local authorities or “other group of interest” to the Minister of Industry and Trade, the decision by the Council of Ministers
   financial instruments: income earned from activity is exempted from income tax up to the equivalent of 50% of revenues from exports or services generated by a firm within the zone over a specified period of time (10 years but not exceeding the 15th year from the establishment of the zone)
   time schedule of conforming to Article 3 (7 years): no explicit time limit set

3. Interest subsidies on bank loans
   implementation date: 19 January 1995
   objective: to encourage exports of turnkey plants, complete installations, construction projects, machinery, vehicles, vessels transportation equipment, other equipment, and construction and installation services
   management: the MFER and its Export Credit Insurance Corporation
   eligibility: export contracts have to be insured by the Export Credit Insurance Corporation and apply, in particular, to large engineering projects, capital and transportation equipment, and construction and installation services
   financial instruments: the minimum value of the contract is ECU100,000; the credit has to be provided for at least 6 months but not longer than 7 years. Subsidy, calculated as the difference between the actual cost of the loan on domestic or foreign markets plus the margin usually charged by banks, may not exceed one-fifth of the actual cost of the loan increased by the margin.
   time schedule of conforming to Article 3 (7 years): no explicit time limit set

4. Credit guarantee schemes
   implementation date: 19 September 1995
   objective: to encourage exports of products of strategic industries such as shipbuilding, machine tools, aircraft, to support privatization projects
   management: considered by the MFER, but the final decision made by the Council of Ministers or the Minister of Finance. Administration by the MoF.
   financial instruments: guarantees cover repayment of loans for (1) development and maintenance of infrastructure; (2) environmental protection; (3) restructuring and modernization of firms; (4) short-term investment in new technologies meeting environmental standards; and (5) projects which (a) will generate exports of at least 20 percent of goods and services; (b) stimulate development of new technologies; and (c) are located in regions with high structural unemployment. In addition, they may also cover loans for purchase of raw materials or final inputs for production of investment goods for exports when the value exceeds ECU10 million and the production cycle is longer than 6 months; and initiation of government-sponsored privatization programs. The guarantee may cover up to 60% of the utilized credit, including interest repayments (the Council of Ministers may waive this provision). The 1995 ceiling was $1.9 billion, of which $1.5 billion was for foreign loans. Disbursements as of November 20, 1995: guarantees on domestic loans—$48.7 million; guarantees on foreign loans—$293.4 million.
   time schedule of conforming to Article 3 (7 years): no explicit time limit set

5. Export Insurance Guarantees by the State Treasury
   implementation date: 7 July 1994
   objective: to encourage exports through insuring contracts
   management: the Export Credit Insurance Corporation owned by the State Treasury; MFER publishes a list of countries classified by level of risk.
   financial instruments: coverage on bank loans negotiated by the Corporation, and by direct loans from the State Budget. The maximum amount subject to insurance guarantees was $1.5 million, and the volume PL ZL 40 million.
   time schedule of conforming to Article 3 (7 years): no explicit time limit set
(by end-November) amounted to around $250 million, well below $1.9 billion budgeted for this year. In the same period there was not a single case of disbursement under the interest subsidy program despite a budget commitment of $8 million.

**Safeguards**

Although the EA stipulates the elimination of tariffs and quantitative restrictions on industrial imports, it also allows withdrawal from obligations under the EA to protect specified interests. The EA does not ban the use of nontariff measures under specified circumstances. Derogations from free trade are allowed for especially sensitive products. Poland and the EU alike can resort to any of eight safeguard clauses contained in the EA. Two of these can be employed under explicit conditions and six are specific to particular groups of products or circumstances regarded by EA signatories as unique to an economy in transition from central planning. Since the safeguard clauses are nontransparent, softly disciplined and loosely defined, they are “open to virtually unconstrained administrative discretion.”

In fact, the EA provides weaker disciplines on the use of safeguard measures than those of the GATT. The CEFTA agreement, though encompassing countries at a similar level of development, retains all the safeguard clauses included in the EA. The restructuring clause was used to justify the increases in tariffs—not to exceed the respective MFN applied rate and for up to a three year period—on imports from “free-trade” partners of telecommunication equipment (since 1994), of petroleum products (in 1996 raised from 12 to 15 percent), oil (raised to 25 percent in 1996), and trucks, trailers, special vehicles, and bodies chassis (raised from 30 to 35 percent). In the cases discussed above no injury to domestic producers as an explanation for adopted measures had to be demonstrated.

These derogations from trade liberalization envisaged in the agreements were not part of a comprehensive program of restructuring because there was none. Rather, they resulted from pressures either to protect domestic producers or to attract foreign investors.

**Tariff Structure**

Poland’s tariff structure does not serve well the objective of maximizing the national welfare. Its major deficiencies are diversification in the structure of tariffs and discrimination due to preferential trading agreements.

On the grounds of efficiency and political economy, the best option is a relatively low uniform tariff structure. It is also desirable on grounds of administrative simplicity and transparency. It eliminates incentive to misclassify products. It simplifies customs clearance procedures and thereby reduces import costs. It may also help to countervail lobbying efforts for protection. Furthermore, low and uniform tariff rates minimizes the net welfare cost. Different tariff rates trigger changes in the relative prices of products which in turn may seriously distort production and consumption patterns.

Although by the standards of developing countries Poland’s simple average MFN applied rate of 27 percent is not high, it is almost four times as high as that in the EU, which had a simple average MFN rate of 7 percent in 1993. As a country with relatively low GDP and foreign trade turnover, Poland has the most to lose from imposing tariffs, but it still uses them extensively.
Poland chose to bind its MFN tariff rates at the maximum allowable level when it joined the WTO in 1995, suggesting the further ebbing of commitment to trade liberalization. Product lines with tariffs set below their pre-Uruguay Round applied rates (in 1989) account for 28.3 percent of total product lines. The share was particularly low for transport equipment (table 5). Again the same product group—motor vehicles—seems to be mainly responsible for Poland's proportion of tariff lines subject to bindings lower than that in the EU. Except for textiles and clothing, post-Uruguay Round MFN weighted applied rates in the EU will be significantly lower than those in Poland. The largest absolute differences are for wood, pulp, paper, and furniture (10.1), transport equipment (5.2), and non-electric machinery (5.0). Leaving aside agricultural products, whose tariff levels are difficult to estimate, the absolute differences in bound rates between the EU and Poland are even larger.

### Table 5 Bindings and Levels of Most Favored Nation Tariff Rates after the Uruguay Round

<table>
<thead>
<tr>
<th></th>
<th>Percentage of Imports</th>
<th>Percentage of Imports GATT Bound Below</th>
<th>Applied Rate Weighted by 1989 Imports</th>
<th>Post-Uruguay Bound Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agricultural Products,</td>
<td>EU - 100.0</td>
<td>EU - 41.4</td>
<td>EU - 3.7</td>
<td>EU - 3.8</td>
</tr>
<tr>
<td>Excl. Fish</td>
<td>PL - 98.4</td>
<td>PL - 5.3</td>
<td>PL - 9.7</td>
<td>PL - 39.9</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>EU - 100.0</td>
<td>EU - 43.3</td>
<td>EU - 2.9</td>
<td>EU - 3.2</td>
</tr>
<tr>
<td></td>
<td>PL - 92.8</td>
<td>PL - 36.1</td>
<td>PL - 6.9</td>
<td>PL - 8.5</td>
</tr>
<tr>
<td>Wood, Pulp, Paper, and</td>
<td>EU - 100.0</td>
<td>EU - 16.7</td>
<td>EU - 0.3</td>
<td>EU - 0.5</td>
</tr>
<tr>
<td>Furniture</td>
<td>PL - 100.0</td>
<td>PL - 54.4</td>
<td>PL - 10.4</td>
<td>PL - 7.0</td>
</tr>
<tr>
<td>Textiles and Clothing</td>
<td>EU - 100.0</td>
<td>EU - 70.5</td>
<td>EU - 8.7</td>
<td>EU - 8.5</td>
</tr>
<tr>
<td></td>
<td>PL - 100.0</td>
<td>PL - 32.2</td>
<td>PL - 5.3</td>
<td>PL - 14.7</td>
</tr>
<tr>
<td>Leather, Rubber, and</td>
<td>EU - 100.0</td>
<td>EU - 59.7</td>
<td>EU - 4.9</td>
<td>EU - 4.9</td>
</tr>
<tr>
<td>Footwear</td>
<td>PL - 100.0</td>
<td>PL - 43.1</td>
<td>PL - 8.0</td>
<td>PL - 9.7</td>
</tr>
<tr>
<td>Metals</td>
<td>EU - 100.0</td>
<td>EU - 21.6</td>
<td>EU - 1.0</td>
<td>EU - 1.7</td>
</tr>
<tr>
<td></td>
<td>PL - 100.0</td>
<td>PL - 16.4</td>
<td>PL - 5.2</td>
<td>PL - 8.3</td>
</tr>
<tr>
<td>Chemical and</td>
<td>EU - 100.0</td>
<td>EU - 44.5</td>
<td>EU - 3.8</td>
<td>EU - 4.4</td>
</tr>
<tr>
<td>Photographic Supplies</td>
<td>PL - 99.0</td>
<td>PL - 78.5</td>
<td>PL - 7.3</td>
<td>PL - 7.6</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>EU - 100.0</td>
<td>EU - 22.2</td>
<td>EU - 5.5</td>
<td>EU - 6.2</td>
</tr>
<tr>
<td></td>
<td>PL - 17.7</td>
<td>PL - 6.8</td>
<td>PL - 10.7</td>
<td>PL - 9.2</td>
</tr>
<tr>
<td>Non-electric Machinery</td>
<td>EU - 100.0</td>
<td>EU - 66.5</td>
<td>EU - 1.4</td>
<td>EU - 1.6</td>
</tr>
<tr>
<td></td>
<td>PL - 98.7</td>
<td>PL - 38.4</td>
<td>EU - 6.4</td>
<td>PL - 8.4</td>
</tr>
<tr>
<td>Electric Machinery</td>
<td>EU - 100.0</td>
<td>EU - 65.9</td>
<td>EU - 5.4</td>
<td>EU - 5.2</td>
</tr>
<tr>
<td></td>
<td>PL - 100.0</td>
<td>EU - 22.7</td>
<td>EU - 9.5</td>
<td>PL - 11.5</td>
</tr>
<tr>
<td>Mineral Products,</td>
<td>EU - 100.0</td>
<td>EU - 20.0</td>
<td>EU - 0.5</td>
<td>EU - 0.7</td>
</tr>
<tr>
<td>Precious Stones, &amp; Metal</td>
<td>PL - 100.0</td>
<td>PL - 27.2</td>
<td>EU - 2.2</td>
<td>PL - 2.6</td>
</tr>
<tr>
<td>Manufactures nes</td>
<td>EU - 100.0</td>
<td>EU - 54.1</td>
<td>EU - 2.5</td>
<td>EU - 2.6</td>
</tr>
<tr>
<td></td>
<td>PL - 98.5</td>
<td>PL - 27.4</td>
<td>EU - 5.8</td>
<td>PL - 7.7</td>
</tr>
<tr>
<td>All Merchandise Trade</td>
<td>EU - 100.0</td>
<td>EU - 38.6</td>
<td>EU - 2.9</td>
<td>EU - 3.2</td>
</tr>
<tr>
<td></td>
<td>PL - 91.3</td>
<td>PL - 28.3</td>
<td>EU - 6.9</td>
<td>PL - 12.3</td>
</tr>
</tbody>
</table>

Source: Finger and others (1996).
Poland's tariffs are relatively low but not uniform. The higher the dispersion in tariff rates, as measured by standard deviation (absolute dispersion between items), the larger are potential distortions, since the variance in tariff rates causes the variation in imported product prices. The overall standard deviation of Polish MFN rates of 28 percent is significantly larger than that in OECD countries.

Since tariffs are not uniform, protection (or assistance) offered to domestic producers is not neutral for products at various stages of processing. The amount of protection afforded to the domestic content of a product by the tariff structure of Poland only rises for some sectors. The most restrictive effects on the location of processing activity—as measured by the difference between the rates of effective protection and nominal protection—are in processed meat products (almost three times the nominal rate of 33.5 percent), transport equipment (66 percent over the nominal rate of 19 percent), clothing (54 percent over the nominal rate of 20 percent), and heavy chemicals (50% over the nominal rate of 5 percent).

Preferences and exemptions from uniform treatment for external suppliers may result in losses due to reliance on higher cost supplies than would otherwise be available. Poland's import regime (not unlike that of the EU) has a myriad of preferential arrangements. Maximum tariff rates as well as average weighted and simple tariff rates are highly diversified, reflecting differences in baskets of Polish imports from various trading partners as well as differences in preferential agreements. A measure of the extent of the use of preferences and exemptions is the difference between the applied autonomous rate, or average, and the collected rate. By this standard, preferences and exemptions are a trademark of Poland's tariff schedules. Based on tariff schedules and projected imports in 1996, with the average autonomous rate of 34.5 percent and the collected rate of 8.2 percent, this difference amounts to 26.3 percent; for the MFN rate, the difference is 18.1 percent.

Granting preferential treatment to suppliers may be purely trade diverting if it merely compensates for suppliers' cost disadvantage. Imports from preferential partners (the EU, EFTA, and CEFTA countries) account for almost three-fourths of Poland's total imports. These imports are subject to lower tariff rates than goods from other sources. Given their geographical proximity and the economic superpower status of the EU, these countries seem to be Poland's natural trading partners. Therefore, the potential for trade diversion seems to be limited, albeit with some important caveats.

The potential for trade diversion has increased since 1994 as a result of the growing divergence between MFN and preferential treatment of imports. This divergence is reflected in the increased difference between duties on imports from the EU, EFTA and CEFTA partner and those from MFN partners. In 1996 the simple average tariff rate on EU imports, which account for around two-thirds of Poland's total imports, was 7.4 percent, whereas MFN imports were subject to tariffs of 26 percent (for industrial imports corresponding rates are 6.9 percent and 13.4 percent). Table 6 shows that the average rates, weighted by 1995 imports, ranged from 3.1 percent for the Czech and Slovak Republics to 25.7 percent for non-WTO countries (excluding the former Soviet Union countries).

Tariff rates varied considerably in 1996 by import source (see table 7). The variation extended also over agricultural products—meat, live animals, beverages, and tobacco. Rates on imports from CEFTA partners were much lower than on imports from the EU. But both simple and weighted rates applied against imports from the EU were more than fifty percent lower than on MFN partners. These reverse tariff preferences for industrial products will
Table 6 Imports, Directions, and Tariffs by Major Partner (1996 Tariffs Weighted by 1995 Imports)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union</td>
<td>16,913</td>
<td>65</td>
<td>45</td>
<td>6.1</td>
<td>7.5</td>
</tr>
<tr>
<td>EFTA</td>
<td>856</td>
<td>3</td>
<td>28</td>
<td>3.6</td>
<td>6.7</td>
</tr>
<tr>
<td>CEFTA, of which</td>
<td>1,646</td>
<td>6</td>
<td>37</td>
<td>3.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Czech/Slovak CU</td>
<td>1,216</td>
<td>5</td>
<td>37</td>
<td>3.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>329</td>
<td>1</td>
<td>30</td>
<td>4.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Slovenia</td>
<td>101</td>
<td>0</td>
<td>25</td>
<td>3.6</td>
<td>4.7</td>
</tr>
<tr>
<td>MFN countries</td>
<td>5,369</td>
<td>21</td>
<td>369</td>
<td>12.0</td>
<td>21.3</td>
</tr>
<tr>
<td>Developing countries, of which</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GSP status</td>
<td>945</td>
<td>4</td>
<td>32</td>
<td>3.9</td>
<td>7.9</td>
</tr>
<tr>
<td>Other developing</td>
<td>882</td>
<td>3</td>
<td>32</td>
<td>4.2</td>
<td>8.9</td>
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<tr>
<td>Other</td>
<td>182</td>
<td>1</td>
<td>395</td>
<td>25.7</td>
<td>39.8</td>
</tr>
<tr>
<td>TOTAL</td>
<td>25,911</td>
<td>100</td>
<td>395</td>
<td>7.1</td>
<td>11.6</td>
</tr>
</tbody>
</table>

Source: Derived from Central Statistical Office Trade Data

increase further in 1999, with 20 percent annual reductions in tariffs on imports from the EU and EFTA that will lead to the elimination of duties (except for motor vehicles until 2002) and with the elimination of duties on manufactures trade with CEFTA (again with the exception of cars). Although MFN rates will also be reduced; the tariff-induced margin for preferred suppliers will increase in comparison with 1994.

Table 7 Applied Tariff Rates for Selected Products and Trading Partners, 1996

<table>
<thead>
<tr>
<th></th>
<th># of Tariff Lines</th>
<th>Simple Rate</th>
<th>Weighted Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Live Animals (0)</td>
<td></td>
<td>84.6</td>
<td>59.4</td>
</tr>
<tr>
<td>EU</td>
<td>2,133</td>
<td>15.9</td>
<td>6.6</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>562</td>
<td>3.2</td>
<td>12.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>372</td>
<td>10.8</td>
<td>13.1</td>
</tr>
<tr>
<td>Beverages and Tobacco (1)</td>
<td></td>
<td>238.2</td>
<td>153.7</td>
</tr>
<tr>
<td>EU</td>
<td>578</td>
<td>20.4</td>
<td>23.5</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>8</td>
<td>5.0</td>
<td>9.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>6</td>
<td>9.8</td>
<td>10.0</td>
</tr>
<tr>
<td>Fuels (3)</td>
<td></td>
<td>7.0</td>
<td>0.3</td>
</tr>
<tr>
<td>EU</td>
<td>672</td>
<td>9.8</td>
<td>6.6</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>150</td>
<td>4.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>63</td>
<td>5.6</td>
<td>8.4</td>
</tr>
<tr>
<td>Iron and Steel (67)</td>
<td></td>
<td>17.7</td>
<td>17.8</td>
</tr>
<tr>
<td>EU</td>
<td>4,147</td>
<td>9.0</td>
<td>9.1</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>648</td>
<td>6.7</td>
<td>6.5</td>
</tr>
<tr>
<td>Hungary</td>
<td>123</td>
<td>10.6</td>
<td>10.3</td>
</tr>
<tr>
<td>Chemicals (5)</td>
<td></td>
<td>12.3</td>
<td>11.9</td>
</tr>
<tr>
<td>EU</td>
<td>8,518</td>
<td>6.3</td>
<td>5.6</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>834</td>
<td>0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>297</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other Manufactures (6 to 8 minus 61, 65, 67, 84, and 85)</td>
<td></td>
<td>12.6</td>
<td>12.8</td>
</tr>
<tr>
<td>EU</td>
<td>33,858</td>
<td>5.9</td>
<td>5.4</td>
</tr>
<tr>
<td>C&amp;SK</td>
<td>4,343</td>
<td>1.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>1,578</td>
<td>1.3</td>
<td>0.8</td>
</tr>
</tbody>
</table>
On economic grounds, the widening gap in reverse discrimination is detrimental to national welfare. Although the EU is both an economic superpower and Poland's natural trading partner, it does not produce all products at the lowest cost worldwide. Expensive EU products which are sold in Poland thanks to high MFN tariffs obtain rents at the expense of their Polish users. The reduction of tariff rates would yield several important benefits: it would increase the range of products available to consumers; it could lower prices thanks to increased competition from MFN imports; and it would reduce welfare losses associated with trade diversion exacerbated by the increasing difference between MFN tariffs and tariffs on imports from the EU. Furthermore, since increased imports lead to growth in exports through expansion of commercial contacts, lowering of tariffs would probably contribute to expansion of exports to other markets and, therefore, the fall in geographic concentration of Polish trade. Considering that Polish producers are already exposed to competitive pressures from EU imports, it is rather surprising that free trade has not spread yet to the Polish MFN trade policy, since the level of protectionism would not significantly change.

The general (MFN) liberalization of access to Polish markets would not have a negative impact on inflows of FDI. Quality FDI is driven by macroeconomic fundamentals such as strong growth performance and a business climate favorable to private sector development on the basis of the principle of national treatment.

Policy Implications

The review of foreign trade policy reveals several deficiencies with a potentially large impact on Poland's international competitiveness. There are deficiencies relating to the policy framework, and deficiencies relating to policies. The deficiencies relating to the policy framework are of a structural nature; they relate to the weaknesses in the institutional framework, and will be discussed in section 6. Suggestions on how to address policy or nonstructural issues are briefly outlined below. First, the practice of temporary tariff exemptions and suspensions should be stopped. It assigns to the state the role of an owner and operator, while simultaneously opening the foreign trade policy making process to unproductive rent seeking activities. Furthermore, this mode of management of foreign trade flows creates barriers to imports and introduces anti-export biases.

Second, the notion of adopting some EU external border measures (which would bring Poland's import regime more in line with that in the EU) should be given a close scrutiny. This would be both good economics (for the reasons discussed earlier) and good politics; this initiative would demonstrate a strong political commitment to adjust to EU membership requirements. Two policy options are possible. The first would be to adopt EU's post-Uruguay MFN tariff schedule. The data presented in table 5 suggests that MFN tariff rates would have to be cut on average by half. The rule of thumb for reducing MFN applied tariff rates on industrial products might be as follows: lower an MFN applied tariff rate to the minimum of: the tariff level applied on the products from the EU; the EU's MFN applied rate.

The second option would be an informal "shadow" customs union without, however, loss of sovereignty over foreign trade policy. It would be initially limited to industrial products. Poland would not only have to adopt EU MFN applied tariff rates but also extend preferential treatment to all countries having special relations with the EU, including its associates in North Africa and developing countries of the Lome Convention. An informal arrangement rather than a formal customs union agreement would entail the loss of some benefits (no
need for rules of origins). On the other hand, the advantage of this arrangement would be that the EU NTBs would not have to be observed.

5. The European Agreements and a Viable Strategy of Integration: Competition Rules and Foreign Trade

In its quest to improve allocative efficiency and boost growth performance, a typical developing country usually has two options: unilateral liberalization of its investment and trade regimes or multilateral liberalization based on reciprocity of concessions. For a country which has too small a presence in world trade to influence international prices and therefore its terms of trade, the best option is unilateral liberalization. Thanks to the EA, Poland has a third option, that of preferential arrangements with a highly developed region (the EU), which is potentially a superior option than that of unilateral liberalization. In addition to preferential access to competitive EU markets and assistance from the EU, the EA adds guidance and credibility to Poland's quest to establish a better economic regime.

Economic integration into the EU is a crucial component of a growth-oriented strategy. Strategy focused on the promotion of greater efficiency through competition, both domestically and internationally, with a view of providing a sounder basis for sustainable and employment-creating economic growth is also a good pre-accession strategy. It will help Poland to meet one of the conditions for EU membership, "the capacity to cope with competitive pressure and market forces within the Union." While the future shape of the CAP and the EU cohesion policy remains to be seen, reducing the gap between Poland's level of development and the EU's average would weaken potential opposition over EU budget financing. A vibrant economy on a path of sustained growth may shorten the pre-accession stage, reduce various transition periods, and increase Poland's capacity to reap benefits (by consumers and producers alike) of membership in the EU. In short, what is good for growth is also good for accession.

Both active competition policy, including policy in relation to foreign investors, and free trade policy, contribute to economic growth. Free trade policy complements competition policy. Both maximize national welfare since unfettered competition, including that from imports, is the best way to foster economic efficiency. Free trade policy does not replace competition policy, because some markets (for nontradables) are difficult to access by foreign firms and foreign firms may become engaged in anticompetitive practices. Apart from a short period in 1990, Poland has pursued an active foreign trade policy (in other words, departing from free trade) designed to protect firms (or factors of production), attract foreign investment, and establish preferential access to other markets. An example of this policy is the Central European Free Trade Agreement. The active trade policy increases the importance of competition rules and policies to offset welfare losses due to the reduction in contestability of domestic markets by foreign firms. Competition rules impose disciplines on firms, whereas integrationist arrangements such as the EA extend discipline to governments.

Foreign Direct Investment, National Treatment, and Business Environment

Economic openness and competitive domestic markets together with observance of sound macroeconomic fundamentals explain to a large extent the variation in economic growth
among countries. A liberal trade and investment regime does not lead to deindustrialization. On the contrary, it generates allocative efficiency gains and growth, which in turn attracts FDI. All development success stories over the last two decades have been based on strong export-orientation combined with low or falling barriers to imports.30

Among various determinants of FDI examined in empirical studies the strength of macroeconomic fundamentals as measured by GDP growth has been found to be consistently important. Ireland’s impressive growth performance, which raised its GDP per capita from 64 percent of the EU average in 1983 to 90 percent in 1996, can be attributed directly to two factors: sound macroeconomic policies and its ability to act as a magnet for US investment.

The EA has contributed to attract FDI inflows. Disciplines implicit in it as well as duty-free access for industrial products have turned out to offset the EA’s drawbacks. The EA ensures investors of national treatment and the general right of establishment for most activities. This has sent a strong signal to all potential investors that Poland is open to FDI and is willing to lock this in. The investment guarantees in the EA have two major drawbacks, however. The EA allows the EU to resort to protectionist measures which may act as a deterrent to investment in some areas; and the rule of origin, used to determine goods and services entitled to preferential treatment and requiring at least 60 percent of local or EU content, is restrictive.31 In surveys of firms in Poland, the rules of origin provision is identified as an important obstacle to exports to the EU.32

Poland has made an important step towards improving the business environment by extending the principle of national treatment to foreign firms in the 1996 Amendment to the 1991 Law on Companies with Foreign Participation. There are still several impediments arising from flawed business law, missing or confused components in the legal and regulatory domains, operation of the tax administration framework, and deficiencies in Poland’s infrastructure. One group of impediments applies only to foreign firms, restricting the scope of the national treatment principle, while a second group applies to foreign and domestic companies alike. The first group includes the restriction on the legal form of conducting business their activities in the form of limited liability and joint stock companies; and permits for transactions involving purchase of equity in a Polish firm.33

The basic problem in the second group of obstacles is that legal institutions that the state sets up in developed nations to support the creation of wealth are yet to be firmly established in Poland. Surveys and interviews suggest considerable legal and bureaucratic barriers to private sector development. The legal system is complex and nontransparent; consider that 31 normative acts govern the registration of a new business, and 56 acts pertain to employment by a private firm.34 Frequent changes in the legal system create uncertainty. The famous 1988 Act on Economic Activity—which opened new areas to private business before the collapse of central planning—was amended 11 times from 1989 to 1994, on average every six months. Despite these changes, the core of the legal system remains rooted in the era of central planning. Furthermore, the legal framework contains loopholes and inconsistencies, and leaves much to be desired in terms of transparency. These weaknesses provide much employment to corporate lawyers and give extra leverage to the state in its dealings with firms.

The paternalism of state administration towards private firms continues to be a barrier to conducting business. Its manifestations include arbitrary law enforcement, excessive powers enjoyed by the administration, and arbitrarily aggressive actions by the tax administration.
The burden of proof falls on a firm. The penalty for a bookkeeping error in tedious VAT calculations amounts to 300 percent of the value of the error compared to 10 percent in the EU. Since the penalty is levied even when a firm discovers the error on its own, the intention of law enforcement seems to be penalization rather than ensuring compliance. Another example is the draft of a law on business self-governance. The law would drastically curtail freedom of economic activity by imposing compulsory membership with fees as well as special reporting requirements. This Damocles' sword has not fallen yet, only because of strong lobbying activity by foreign investors. Yet, the draft has not been definitely removed from the legislative agenda.

Various surveys and reports list other factors discouraging business activity, such as deficiencies in the commercial code limiting ability to raise capital, an inadequate financial sector, the poor quality of domestic telecommunications services, and oppressive and unfairly applied tax codes. One should also take note of the growing concern among foreign investors about the frequent resort to anticompetitive practices by the state authorities. In a recent survey foreign firms were particularly critical of such state-sponsored practices as imposing the level of sales prices, imposing the level of purchase prices, divisions of market, import restrictions, granting the exclusive right to import or distribute certain goods or services, and making the signing of a contract conditional upon meeting unrelated requirements.35

Foreign Trade Framework

The EA is a good vehicle for liberalizing trade and investment regimes as well as domains complementary to trade policy reform but only insofar as the government resists the temptation to exploit its loopholes. The provisions of the EA leave considerable freedom in choosing institutions and economic policy. This is up to the government which course to follow and which EU institutions to emulate. The choice should be oriented toward best international practices even if these are not currently practiced in the EU;36 considering, however, commitments made by the EU under the Uruguay Round agreements as well as pressures to meet the Maastricht criteria, the EU's policies will be evolving towards best international practices. Even if Poland moves faster along these lines, it can only benefit because, if nothing else, it is always easier to adapt to less competitive conditions.

The institutional formation of foreign trade policy does not seem to offer an adequate framework to balance the interests of import-competing industries against those of other producers and consumers. Like many OECD countries, the locus of foreign trade policy making, the Ministry of Economic Cooperation with Abroad, seems to be too closely intertwined with the industrial sector to take into account consumers' interest. The problem is further compounded by the strength of branch ministries (the Ministry of Industry and Ministry of Agriculture) which have authority to take foreign trade-related actions. Decisions regarding access to Polish agricultural markets are assigned to the Ministry of Agriculture, which amounts to asking a fox to guard a henhouse. While the Polish Anti-trust Office compares favorably to competition authorities in OECD countries in terms of its power in foreign trade matters as they affect domestic competition, its status and resources are too limited to have a decisive impact. The EA and WTO, other sources of potential restraint, provide some disciplines. But they cannot be fully relied upon to address this problem. The EA's provisions, going further than those of the WTO, are still too limited to tame special interests of
politicians and import-competing sectors, especially if these do not directly affect trade between Poland and the EU.

The EA imposes disciplines in areas extending beyond those covered by the WTO, but its focus is on preventing negative externalities on the EU rather than on compelling the Polish government to adopt policies that would increase national welfare. Moreover, its objectives are to assure unfettered market access to EU producers rather than to all exporters on a non-discriminatory basis. Equal access for all exporters is a cornerstone of proper trade policy. In brief, the EA, albeit helpful, is not a substitute for a sound trade policy.

Although the currently implemented reform of central government does ‘centralize’ foreign trade policy setting, which usually helps insulate decision making process from lobbying, it does not seem to go far enough to address protectionist dangers. To the contrary, government policy may increase the role of private lobbying in foreign trade policy making. With the inclusion of the Ministry of Economic Cooperation with Abroad (the equivalent of which in many countries pays greater attention to the impact of NTBs and tariffs on national economic welfare) into the new Ministry of Economy and the absence of an independent institution that would balance the interests of import-competing sectors against those of exporters and consumers, the danger of protectionist interests capturing the foreign trade policy making process cannot be ignored.

Poland should consider adopting institutional measures ensuring that the economy-wide impact of foreign trade policy decisions is taken into account and that the foreign trade policymaking process is insulated from private lobbying. Best international practice suggests that this objective can be achieved only when domestic actors depending on imports or exports can voice their views in the policy setting process on an equal footing with import-competing producers. Two broad solutions are possible; placing responsibility at the level of the Prime Minister’s Office, or establishing an independent institution responsible for evaluating and monitoring economic effects of proposed or implemented trade measures on competition (concentration and market structure) and national welfare. Institutions charged with these responsibilities have been established in many countries with the Australian Industries Assistance Commission being the source of inspiration.

However, taking into account exigencies of the EA as well as changes in the global post-Uruguay environment, one might consider granting authority to a single institution to assess and monitor ex post the competition and welfare impact of important policy decisions affecting contestability of domestic markets. Such an institution could be founded by enhancing the status and independence of the existing Office for Consumer Protection and Competition through term-appointment of its President. This arrangement has the potential to generate efficiency and growth gains by giving more balanced weight to competing vested interests and control policy makers’ anti-competition actions. Furthermore, as the social costs of anticompetitive structures and conduct may be much higher in Poland than those in mature market economies, the anti-trust authority should be more activist and operate according to simpler and less subtle rules of action, and should trust less in the discretion of public agencies.

**Competition Rules and State Aids**

The desired outcome of the transition from central planning is the emergence of competitive and contestable markets. Markets are contestable when the relationship among firms are not unduly distorted by anticompetitive governmental or private action and there is unen-
The thrust of Polish competition laws is certainly pro-competitive. Their cornerstone is the Act on Counteracting Monopoly Practices (CMP Act) introduced during the first stages of Poland's transition on 24 February 1990. The CMP was subsequently amended by the Act of 28 June 1991, the Act of 16 April 1993, and the Act of 18 May 1995. The CMP has established two government central agencies dealing directly with competition-related issues: the Anti-Monopoly Office (AMO) now replaced by the Office for Competition and Protection of Consumers, headed by a president appointed (and recalled) by the Prime Minister, and the Anti-Monopoly Court (AMC).

The two major institutions dealing exclusively with competition-distorting practices, the AMO and the AMC, are entrusted with significant powers. The AMO assesses the competition impact of privatization projects; it has the authority to terminate the monopolistic practice and impose fines (up to 15 percent of a firm's after-tax earnings in the preceding year); it is responsible for antidumping investigations; it may break up firms if they have dominant position and permanently restrain competition; and it may object to the recommended restructuring of a firm. The president of the AMO, appointed by the Prime Minister, attends meetings of the Council of Ministers. The AMC supervises the expediency and lawfulness of the AMO's rulings, and provides a forum for appeals by firms against decisions taken by the AMO. Its rulings are final and enforceable—they may be overruled only by extraordinary appeal to the Supreme Court.

How effective are the domestic competition rules in removing impediments to the emergence and survival of competitive markets? Three observations can be made. First, the AMO becomes involved only if there is a suspicion of monopolistic practice by a firm. The actions of a government limiting international contestability of Polish markets such as various tariff or non-tariff barriers do not fall within the purview of the AMO as long as local firms benefiting from less competition do not engage in monopolistic practices. This is so although consumers bear the ultimate cost of higher prices.

Second, the success of the AMO (which is charged with implementation of antitrust laws) in promoting competition hinges critically on actions taken by the government. On top of "demonopolization" and liberalization of market access for foreign goods, services, ideas, and investments on terms comparable to those enjoyed by local competitors, establishing competitive markets also involves privatization. The government may be tempted to boost fiscal returns from the privatization of state-owned enterprises by limiting the scope of competition through raising tariffs or offering exclusive rights to a privatized firm. High Polish tariffs on automobiles to attract foreign investors illustrate the former, and exclusive rights by Polish Telecommunications, Inc. on local calls illustrates the latter. In brief, the problem is that government's competition-distorting actions are not subject to anti-trust law. The major sources of discipline on the government's behavior are international agreements, namely the EA.

Third, the AMO is charged with regulating natural monopolies. This has two drawbacks: in public perception its activity is tantamount to price controls; and regulatory activity takes the AMO's attention from competition problems as they emerge in other areas.

cumbered market access for foreign goods, services and investment. Contestability declines with restrictive regulatory regimes, differentiation in treatment of local and foreign competitors, increases in border and nonborder protection, and anticompetitive practices.

Competition policy (including policy related to foreign investors) plays a major role in the transition from central planning. Free trade policy complements competition policy. Both maximize national welfare since unfettered competition, including that from imports, is the best way to foster economic efficiency. Free trade policy does not replace competition policy, because some markets (for nontradables) are difficult to access by foreign firms, and foreign firms may become engaged in anticompetitive practices. Apart from a short period
in 1990, Poland has pursued an active foreign trade policy (departing from free trade) designed to protect firms (or factors of production), attract foreign investment, and establish preferential access to other markets. The active trade policy increases the importance of competition rules and policies to offset welfare losses due to the reduction in contestability of domestic markets by foreign firms. Competition rules impose disciplines on firms, whereas integrationist arrangements such as the EA extend those disciplines to governments.

The EA envisages a transitional period for changing economic legislation to EU standards. Among the regulatory measures affected are legislation on unfair competition and anti-monopolistic regulations now in force in EU countries, which can be deferred by three years after the EA went into effect, and legislation regulating state assistance and subsidies, patterned after EU legislation, whose implementation can be deferred by five years with a provision for another five years. Until these regulations are fully implemented, the GATT subsidy code will be used to assess distortions in market competition caused by monopolistic practices and state subsidies. The absence of these regulations makes Polish exporters more vulnerable to various EU nontariff actions.

While the EA provides some guidelines for reforms compatible with EU requirements, excluding the timetable of mutual concessions regarding access for products and investments, it leaves considerable discretion on the timing and scope of measures to be taken by the Polish government. Effective disciplines of the EA, not unlike those of the Treaty of Rome, focus mostly on trade impact and negative externalities on the EU associated with various measures. The EA does not specify what policies Poland should conduct with third countries as long as these do not affect directly trade between the EU and Poland or the EU’s status as laid out in the EA.\textsuperscript{9} Even for EU members there is a much room for decentralized solutions. Furthermore, some authors argue that the EU law and practices are not natural candidates for implementation on the domestic level because such law and practice have only been applied at transnational level.\textsuperscript{40}

Poland has made a significant progress to harmonize its competition policy with the EU. The EA restrains Poland’s freedom to enact anticompetition policies, albeit in a limited way. The rules necessary for the application of competition provisions of the EA (Article 63), spelled out in Decision No. 1/96 of the Association Council signed on 16 July 1996. The Annex to this Decision sets out the implementing rules for the application of the competition provisions.\textsuperscript{41} The implementing rules are concerned with competence of antitrust authorities, cooperation principles including notification and information requirements, merger controls, and block exemptions. The scope of cooperation between the Polish antitrust authorities and the Commission (DG IV) is limited to competition-distorting actions that may affect trade between the EU and Poland. Cases with no impact on mutual trade are left to the discretion of the Polish antitrust authorities.

In all, it seems that the extent to which Poland may actually rely on the European Commission to enforce the competition rules seems limited. The model of cooperation under the EA has weaker provisions than those in the Agreement on the European Economic Area between the EU and EFTA. The latter requires a full exchange information between the EFTA Surveillance Authority and the EC for cases involving both the signatory EFTA countries and the EU, thus derogating from the normal rules on confidentiality.\textsuperscript{42}

Economies in transition from central planning need a strong and assertive competition policy. Although Poland has dismantled most legacies of central planning, it still has to solve
many structural problems in order to increase its international competitiveness. Despite sig-
nificant progress since 1990, large firms with weak corporate control structures still domi-
nate the economy. Poland's industrial structure remains biased in favor of heavy industries, 
and despite expansion in trade the import penetration remains low. Simplification of sub-
stantive rules in close cooperation with the EC and granting larger power and resources to 
the anti-trust authorities would go a long way to increase Poland's international com-
petitiveness.

While harmonization of competition laws is regarded as satisfactory, Poland has made 
little progress in "state aids" (subsidies) legislation. The EU's rules prohibit governments 
from providing state aids to industrial enterprises; the Commission determines whether state 
support violates the rules and can require that subsidies be repaid. These rules automatically 
apply to EU members. Article 63 (iii) of the EA prohibits state subsidies distorting (or threat-
ening to distort) competition. Agreement on its implementation has not been reached, how-
ever, and GATT disciplines continue to apply. Nontransparency and the absence of monitor-
ing mechanisms distort competition and slow down the shift of resources to internationally 
competitive sectors. Considering that the share of state aids in GDP amounted to 4 percent 
twice the level of the EU, their negative impact on the economy is significant.

The EA offers a good general framework to develop policy built around the notion of 
increasing competition, or more precisely contestability, in Polish markets. But the crux of 
the matter is that while the EA imposes substantial disciplines, it also allows for a great deal of 
flexibility in pursuing policies that may be either detrimental or beneficial at the national 
level. Observing only the EA's minimum requirements or exploring its loopholes is counter-
productive. Following the best international practice in respective areas should be a guiding 
principle rather than simply transplanting EU solutions.

6. Conclusion

Despite impressive economic growth performance and gains in reintegrating into the world 
economy, much remains to be done to get the Polish economy ready for accession and re-
duce future shocks of a full integration in the EU. Reforms of foreign trade institutions and 
policies alone will not accelerate economic restructuring through relocation of resources to 
export-oriented sectors capable of competing in international markets and will not strengthen 
growth potential within the framework of integration into the EU. Broader change is needed 
to achieve these goals.

Contemporary research often referred to as a "new foreign trade agenda" suggests that 
the best elements of a viable strategy providing a sound basis for sustainable and employ-
ment-creating economic growth are contestability of domestic markets and a business friendly 
environment. The latter is important not only for FDI but also for domestic firms. The com-
petitiveness of Polish firms, both domestic and foreign-owned, ultimately depends on com-
petition at home from imports and domestic sources alike. This in turn hinges critically on 
removal of barriers to entry to private business, leveling the playing field to all firms by not 
offering special tax treatment and other forms of subsidies (state aids), curbing bureaucratic 
hampering, ensuring transparency of regulations, and so forth.

These measures would go beyond foreign trade and FDI policies per se. However, their 
implementation is crucial to maximization of national economic welfare. A framework for
sound foreign trade policy has linkages to other policy and institution building areas. Poland's strategy of accession to a market-based economic system would greatly benefit from directly addressing these linkages and a rapid establishment of export-oriented foreign trade regime.

This paper identifies several areas where institutions and policies diverge widely from best international practices and may undermine the capacity of the Polish economy to deal successfully with two immediate challenges: that of increasing competition in domestic markets (through the gradual reduction of tariffs on imports from the EU) and increasing competitiveness of Polish exports in EU markets (through the liberalization envisaged in the Uruguay Round Agreement). While it is impossible to assess quantitatively welfare losses associated with the failure to implement these policies, one suspects that these are substantial and may increase rapidly.

Many weaknesses of Poland's foreign trade policy stem from institutional design that is not conducive to sound policies. The foreign trade policy process has been increasingly captured by narrow sectoral interests. With incorporation of the Ministry of Foreign Trade into a newly established Ministry of Industry and Trade, the containment of protectionist pressures will become increasingly difficult. In order to prevent this outcome, institutional measures should be adopted ensuring that economy-wide impact of foreign trade policy decisions is taken into account and that the foreign trade policy making process is insulated from private lobbying. Best international practice suggests that this objective can be achieved only when domestic actors depending on imports or exports can voice their views in the policy setting process on an equal footing with import-competing producers.

Taking into account exigencies of the EA as well as changes in the global post-Uruguay environment, one might consider granting authority to a single institution to assess and monitor ex post the competition and welfare impact of important policy decisions affecting contestability of domestic markets. It might involve enhancing the status and independence of the existing Office for Consumer Protection and Competition. The Office should have a final say over the impact of trade measures on market structure, concentration, and so forth. As the social costs of anti-competitive structures and conduct are probably much higher in Poland than in mature market economies, the anti-trust authority should be more activist and operate according to simpler and less subtle rules of action, and should trust less in the discretion of public agencies.

Since the EA does not provide strong disciplines in this respect, the responsibility for designing them rests solely with the Polish authorities. Thus, in addition to enhancing status of competition-rules enforcement, one might consider coordinating competition policy with other CEFTA members. Simplification of substantive rules in close cooperation with the European Commission together with adoption of these rules by Poland and other CEFTA countries would go a long way to increase Poland's international competitiveness and attract FDI to the region.

Although the Polish import regime is not NTB-ridden, the temptation to resort to NTBs has been on the increase. Considering the negative impact of NTBs on competition from imports, a unilateral ban on the use of NTBs on imports, or at least imports from highly developed countries and other CEFTA countries, might be considered. Whatever the policy course taken, one should seek to ensure that decisions concerning activation of safeguards in form of increased tariffs should be made taking into account interests of both users and producers of import-competing products. This should also include measures erecting
technical barriers to trade such as Poland’s infamous Certification Law—although one may argue that intent of the Certification Law is not protectionist, it nonetheless erects a technical barrier to trade. It seems that its benefits in terms of protecting consumers against “dangerous” products are minimal, whereas potential losses associated with the decline in contestability of domestic markets and the negative impact on foreign investors’ assessment of business climate might be huge. Further, one may consider negotiations with CEFTA members and the EU to reach an agreement on banning the use of antidumping measures on their respective imports.

Another source of distortion is the practice of temporary tariff exemptions and suspensions. Except for bureaucratic empowerment, there is no justification for this practice. It erodes credibility of Poland’s commitment to establish a modern market economy. It assigns to the state the role of an owner and operator, while simultaneously opening the foreign trade policy making process to unproductive rent seeking activities. Last but not least, this mode of management of foreign trade flows creates barriers to imports, introduces anti-export bias in the economy, and discourages FDI inflows.

It is also stunning that liberalization under preferential trade agreements has not percolated to Poland’s general trade policy. With liberalization of trade in industrial products under the EA and CEFTA, the potential for trade diversion increases. In order to reduce reverse discrimination implicit in Poland tariff structure, MFN tariffs should be at least brought to EU levels. In addition, negotiations with CEFTA countries might be initiated to introduce similar measures; this would effectively eliminate the need for maintaining burdensome and costly rules of origins in their mutual trade.

The links between foreign trade policy and climate for foreign investment are pervasive. Empirical evidence suggests that luring FDI through offering import protection is not only costly but also counterproductive. Poland has underperformed in terms of attracting FDI because business environment has not been sufficiently friendly or its trade regime sufficiently liberal. Although FDI has been on the increase, sustaining momentum can be best accomplished by removing existing sources of distortions in institutions and instituting policies complementary to trade and investment regimes.

Although the EA can be criticized for not going far enough in extending concessions or imposing economically sound disciplines, this analysis offers a different conclusion. The EA seems to be a good vehicle for liberalizing trade and investment regime as well as domains complementary to trade policy reform but only insofar as the government resists the temptation to exploit its loopholes. The provisions of the EA allow considerable freedom in choosing institutions and economic policy. It is up to the government which course to follow and which EU institutions to emulate. The choice should be oriented toward best international practices even if these are not currently practiced in the EU. Even if Poland moves faster along these lines, it can only benefit from this course because, if nothing else, it is always easier to adapt to less competitive conditions.
Notes

3. A special economic zone (SEZ) was set up in Suwalki and Katowice in June 1996. The latter is directly associated with investment by General Motors.
4. The ranking takes into account a geographical reorientation of trade in line with comparative advantage (away from former members of the CMEA), growth in manufactures exports to OECD markets and their share in GDP, and the increase in the value of total exports over the year preceding the collapse of central planning. See Kaminski and others (1996).
5. An important problem associated with the analysis of NTBs is that their trade effects or nominal equivalents are very difficult to estimate. See UNCTAD (1988) for a discussion of problems in the use and interpretation of NTB inventory data.
6. A survey suggests the NTB-induced level of EU protection for textiles and clothing lies between 30 to 50 percent. See S. Laird and A. Yeats, (1990), chapter V.
9. The different national classification methods of FDI complicates comparisons between countries. While in Portugal non-cash contributions are taken into account as part of FDI, in Spain and Poland only money inflows are considered. This leads to an inflation of the Portuguese data. Different sources of methodological and data problems also exist.
12. For a thorough discussion, see Krugman (1994), 38-51.
13. See Baldwin (1989), 248-281. Traditional trade models suggest that capital and/or labor mobility brings convergence; thanks to changes in relative prices brought about by lower import prices and improved export prices, and a higher marginal product per capita attracting higher investment and growth. Furthermore, since a share of Poland's trade with the EU is higher than that for the EU, trade will be of more benefit to Poland.
15. The concern that EU's "associates" in Central Europe would become marginalized into spokes was forcefully expressed in Baldwin (1994).
16. While forces at hand might have been different, a similar phenomenon was observed in Ireland albeit after accession to the EU. See Barry (1996).
17. For more details, see European Bank for Reconstruction and Development (1994).
19. The value of FDI flows to Poland projected for 1996 would be around 40-50 percent of the 1995 level in Spain.
21. The term contestability includes not only issues of market access for foreign firms or investors as embodied in tariffs and narrowly conceived non-tariff barriers but also market access implications of domestic policies and regulations (e.g., standards requirements, environmental standards, phytosanitary measures) underpinning business activities.
22. The existence of several safeguards induces firms to shop around for the easiest protectionist option and thereby loosens government's grip over foreign trade policy. See Hoekman (1995).
24. The welfare loss (total deadweight) increases as tariff structure becomes more diversified. A uniform nominal tax minimizes the net welfare cost insofar as two conditions are met: uniform import demand elasticities across commodities, and negligible cross-price effects. See Panagariya and Rodrik (1993).
25. After tariff changes agreed at the Uruguay Round are implemented, Poland's weighted average MFN applied rate will still be more than twice as high as that of the EU—6.9% as compared to 2.8%. See Finger and others (1996), 28 and 37.
26. In 1993 the standard deviation of EU MFN tariffs was 6.1 percent; US tariffs was 8.6 percent; and Finland's tariffs amounted to 12.7 percent. See OECD (1996), p.40.
27. Derived from estimates in Marczewski (1996). Marczewski’s estimates for 18 industrial sectors shows that the rate of effective protection averaged in 1996 over 26 percent over the corresponding nominal rate. This compares favorably with OECD where the ERPs averaged two times the corresponding nominal rate in the late 1980s. See Laird and Yeats (1990), but with one caveat—Poland’s rates are significantly higher.

31. The EA initially did not allow for cumulation in Central European countries as a group. The 1993 Copenhagen summit of the EC recognized the restrictiviness of this arrangement, and limited cumulation was allowed in late 1994.
33. Most of these are obtained from a 1996 report by the American Chamber of Commerce in Poland. This report is a collective effort by US law firms and consulting companies operating in Poland.
34. See Kamiński (1995).
35. See the INDICATOR Survey.
36. There seems to be a consensus among trade economists that in the era of globalization of production and investment the best trade policy is that of free trade. The EU import regime is still far from this ideal. For an account what components constitute best practice, see Hoekman (1995), 80-93.
37. Institutional rules of foreign trade policy setting too often seem to be overlooked by economists and policy makers alike. For the discussion of their importance in the context of economies in transition, see Winters (1995).
40. See Fingleton and others (1996), 54-56.
41. The implementing rules are inspired by the 1986 OECD Council Recommendation on restrictive business practices affecting international trade and Article V of the EU-US agreement. The latter contains the principle of “positive comity” according to which the government may request the other’s authorities to initiate remedial actions against anticompetitive activities carried out in its jurisdiction but substantially affecting other partner’s important interests. Article 2 (2.2.) of the implementing rules spells out this principle.

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TABLE 2-13 LEADING TO BORROWERS IN LATIN AMERICA AND THE CARIBBEAN, BY SECTOR, FISCAL YEARS 1990-99

\[\text{millions of U.S. dollars}\]

<table>
<thead>
<tr>
<th>Sector</th>
<th>FY90-94</th>
<th>FY95</th>
<th>FY96</th>
<th>FY97</th>
<th>FY98</th>
<th>FY99</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>610.1</td>
<td>440.3</td>
<td>226.3</td>
<td>730.6</td>
<td>342.0</td>
<td>520.4</td>
</tr>
<tr>
<td>Education</td>
<td>564.9</td>
<td>747.1</td>
<td>433.1</td>
<td>61.5</td>
<td>1,199.9</td>
<td>398.6</td>
</tr>
<tr>
<td>Electric power and other energy</td>
<td>257.0</td>
<td>161.5</td>
<td>465.4</td>
<td>56.5</td>
<td>323.0</td>
<td>54.3</td>
</tr>
<tr>
<td>Environment</td>
<td>498.4</td>
<td>1,859.5</td>
<td>11.9</td>
<td>630.2</td>
<td>562.5</td>
<td>1,330.5</td>
</tr>
<tr>
<td>Finance</td>
<td>42.3</td>
<td>-</td>
<td>8.0</td>
<td>-</td>
<td>62.8</td>
<td>40.0</td>
</tr>
<tr>
<td>Mining</td>
<td>82.8</td>
<td>-</td>
<td>41.0</td>
<td>-</td>
<td>39.5</td>
<td>-</td>
</tr>
<tr>
<td>Multisector</td>
<td>850.7</td>
<td>328.6</td>
<td>110.9</td>
<td>121.3</td>
<td>17.7</td>
<td>2,999.0</td>
</tr>
<tr>
<td>Oil and gas</td>
<td>70.1</td>
<td>11.0</td>
<td>10.6</td>
<td>-</td>
<td>130.0</td>
<td>-</td>
</tr>
<tr>
<td>Population, health, and nutrition</td>
<td>266.4</td>
<td>94.6</td>
<td>1,086.4</td>
<td>136.8</td>
<td>824.0</td>
<td>309.4</td>
</tr>
<tr>
<td>Public sector management</td>
<td>427.9</td>
<td>821.4</td>
<td>666.4</td>
<td>614.0</td>
<td>971.2</td>
<td>97.2</td>
</tr>
<tr>
<td>Social protection</td>
<td>634.7</td>
<td>500.0</td>
<td>262.0</td>
<td>465.0</td>
<td>284.0</td>
<td>1,297.9</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>886.7</td>
<td>421.0</td>
<td>530.0</td>
<td>1,496.0</td>
<td>970.1</td>
<td>544.5</td>
</tr>
<tr>
<td>Urban development</td>
<td>340.7</td>
<td>350.0</td>
<td>20.0</td>
<td>100.0</td>
<td>117.0</td>
<td>102.8</td>
</tr>
<tr>
<td>Water supply and sanitation</td>
<td>339.1</td>
<td>221.5</td>
<td>204.0</td>
<td>200.0</td>
<td>190.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Total</td>
<td>5,555.6</td>
<td>6,060.4</td>
<td>4,437.5</td>
<td>4,562.7</td>
<td>6,039.7</td>
<td>7,736.8</td>
</tr>
</tbody>
</table>

Of which: IBD                      | 5,267.3 | 5,715.2 | 4,047.2 | 4,137.5 | 5,679.5 | 7,133.3 |
IDA                                  | 288.3   | 345.2  | 390.3  | 125.2  | 360.7  | 603.6  |

Of which: BRD                      | 5,267.3 | 5,715.2 | 4,047.2 | 4,137.5 | 5,679.5 | 7,133.3 |
IDA                                  | 288.3   | 345.2  | 390.3  | 125.2  | 360.7  | 603.6  |

Note: Numbers may not add to totals because of rounding.
a. See Explanatory Note, Table 1 (page 10).

Response to the financial crisis

Since the onset of the East Asia financial crisis, the Bank has been working with LAC countries to identify areas in which Bank support could best help address the adverse effects of the crisis. In FY99, the Board of Executive Directors approved a new lending tool, the Special Structural Adjustment Loan (SSAL), to help these countries regain financial market confidence. The SSAL, which carries higher interest rates and shorter maturities than a normal Bank loan, aims to help remove major structural impediments to growth, and to protect and enhance safety nets. Argentina and Brazil have received Bank support under this umbrella. The Argentina SSAL aims to help maintain confidence in the domestic banking system, deepen capital markets, enhance the efficiency of regulatory institutions, and strengthen intergovernmental fiscal relations.
### Table 2-14: World Bank Commitments, Disbursements, and Net Transfers in Latin America and the Caribbean, Fiscal Years 1994-99

(millions of U.S. dollars)

<table>
<thead>
<tr>
<th>Item</th>
<th>Argentina 1999</th>
<th>Brazil 1999</th>
<th>Mexico 1999</th>
<th>Total region 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total amount</td>
<td>3,226</td>
<td>9,581</td>
<td>3,912</td>
<td>11,719</td>
</tr>
<tr>
<td>1999 Disbursements</td>
<td>1,686</td>
<td>6,860</td>
<td>4,282</td>
<td>12,828</td>
</tr>
<tr>
<td>1999 Undisbursed balance</td>
<td>1,538</td>
<td>2,726</td>
<td>3,522</td>
<td>7,782</td>
</tr>
<tr>
<td>1999 Repayments</td>
<td>786</td>
<td>3,000</td>
<td>1,309</td>
<td>4,395</td>
</tr>
<tr>
<td>1999 Net disbursements</td>
<td>1,653</td>
<td>3,964</td>
<td>971</td>
<td>7,614</td>
</tr>
<tr>
<td>1999 Interest and charges</td>
<td>1,193</td>
<td>1,944</td>
<td>565</td>
<td>3,702</td>
</tr>
</tbody>
</table>

Note: The table shows the three countries with the largest lending commitments in the Region over the past two fiscal years (FY98-99).

a. Disbursements from the two Special Funds are included through fiscal 1996.

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The reform package has measures to safeguard current social protection programs. The Bank also approved another special operation in Argentina, the Special Repurchase Facility Support Loan, which will lend credibility to the banking system by reducing the likelihood of liquidity constraints, in the context of the country's currency board arrangement.

Special assistance to Brazil is being provided through a program of special sectoral adjustment loans that support social protection, social security, public administration, and banking. The package includes lending of up to $4.5 billion in support of reforms, covering the FY99-FY02 period. Of this amount, the Board approved in FY99 two adjustment loans totaling $1 billion to support social protection and social security reforms. The Social Protection Loan will help the government protect social expenditures during the period of fiscal austerity and reduce the impact on the most vulnerable, while the Social Security Loan is supporting the first phase of the Social Security Program.

**Protecting the poor in the face of crisis and natural disaster**

Efforts to protect the poor have been an important part of the Bank's response to the social consequences of the financial crisis. Assistance

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**Figure 2-9: Latin America and the Caribbean: IBRD and IDA Lending Commitments by Sector, Fiscal Year 1999**

- Urban development: 16%
- Education: 14%
- Social protection: 13%
- Rural sector management: 10%
- Water supply & sanitation: 7%
- Agriculture: 5%
- Health and nutrition: 4%
- Industry: 3%
- Electricity: 3%
- Finance: 3%
- Transport: 2%

Total $7.7 billion