TRADE LIBERALISATION AND THE AUTOMOTIVE MANUFACTURING SECTOR

A Submission to the Productivity Commission's Inquiry into Post 2005 Assistance Arrangements for the Automotive Manufacturing Sector

May 2002

Chamber of Commerce and Industry
WESTERN AUSTRALIA

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1. INTRODUCTION AND SUMMARY

Background

This submission details the views of the Chamber of Commerce and Industry of WA (CCI) on the Productivity Commission's Inquiry into *Post 2005 Assistance Arrangements for the Automotive Manufacturing Sector*.

The Government's previous review determined that automotive vehicle tariffs should be frozen at 15 per cent between 2000 and 2005 and step down to 10 per cent in 2005. This Productivity Commission inquiry is to consider recommendations for tariff and other assistance beyond that date.

CCI Position

CCI exists to serve its members by providing quality, cost-effective support and services to help members build their business, and by lobbying government to promote an economic and legislative environment that encourages the development of responsible private enterprise. This service is currently provided to over 5,000 members throughout WA.

CCI supports the January 2005 reduction to the passenger motor vehicle tariff and believes that tariffs should reduce further beyond 2005 to match the general manufacturing rate of assistance of 5 per cent.

Despite large reductions in assistance since the early 1990s, the automotive manufacturing sector today remains one of the most highly protected industries in Australia. The cut in passenger motor vehicle tariffs scheduled for January 2005 will yield and effective rate of protection of 10 per cent for this sector, which is still over double the average rate of assistance afforded to the rest of Australian manufacturing.

CCI believes that the decision on levels of assistance for this sector after 2005 must be driven by the objective of serving the interests of the whole Australian community. It believes that past decisions to provide high levels of assistance to this sector have given undue weight to the interests of particular regions and producers and not enough to the more diffuse, but not less important, interests of the wider community.

In particular, past decisions have tended to benefit the manufacturing industries of Victoria and South Australia, but damage other states and sectors – particularly exporting industries.

In Western Australia, for example, high passenger motor vehicle tariffs mean that business costs are higher than they otherwise would be, while consumers have less income to spend on state produced goods and services.

Exporting states and those with little or no direct involvement in vehicle manufacturing are most heavily penalised under current high vehicle tariffs, and WA loses on both counts.

CCI understands that whatever direction tariff policy takes there will inevitably be losers and winners, and that the economic damage which tariffs inflict on WA might be deemed justified because of the benefits they yield for the whole Australian community.

But inflicting losses on the bulk of the community in order to benefit a narrow if vocal and visible section of it can be justified only if the aggregate benefits of such a policy can be clearly demonstrated to exceed the costs.

CCI doubts that this could be the case, and argues further that the burden of proof should rest with those who demand community support. It is for the advocates of higher tariffs to prove their case.

The Productivity Commission report and this submission show evidence that the automotive industry has matured over the past ten years, and that reductions in automotive tariffs from 1987 to 2000 have not affected the sector in a markedly adverse manner. In fact, it is evident that other factors have played a larger role in determining the sector's performance over this time.

Another concern that must be considered in this process is Australia's obligations under its international trade commitments and treaties, both with the WTO and particularly with APEC. Australia has been an advocate of trade liberalisation in these arenas, and its unilateral tariff reduction policy has leant credibility to its trade liberalisation efforts. It is important that Australia retains this integrity and implements its trade commitments.

In summary CCI supports the following courses of action:

- That the Government continue to press for reductions in the tariff and other trade barriers implemented by Australia's current and potential trading partners.
- That the tariff on passenger motor vehicles continue to reduce beyond the 10 per cent level scheduled for 2005, to a point where it matches the general manufacturing tariff rate;
- That the general manufacturing tariff (including tariffs on passenger motor vehicle and light commercial vehicles) be reduced to nil by 2010, as agreed under the 1994 APEC Leaders' Declaration of Common Resolve.

2. TARIFF REDUCTIONS POST 2005

National Economic Welfare Considerations

Tariffs distort the market economy and cause income and welfare transfers between groups. This issue is central to the automotive tariff debate.

The imposition of a tariff results in a transfer of consumer surplus to producers and the government, whilst also causing a deadweight loss to the economy as a whole, brought about by a tariff's distortion of incentives to consume and produce.

The case of the Australian automotive industry is unique as the bulk of transfers of the producer surplus is enjoyed by handful of producers located in two states. The remaining states are substantial net losers.

Employment Effects

Perhaps the most often cited reason for maintaining high tariffs is that their removal would lead to job losses and unemployment. However, the argument ignores the fact that trade assistance afforded to a sector comes at the detriment of other industries in the domestic economy. This is because as an industry grows under the shade of trade protection, it utilises more resources (e.g. labour), which may be sourced from unprotected sectors. As a result, outputs in these sectors fall. Even if there are unemployed resources available for work in the protected sector, the resulting decrease in imports due to a tariff should be expected to lead to a decline in employment in export industries[1]. As John Maynard Keynes once noted:

> *"Imports are receipts and exports are payments. How as a nation can we expect to better ourselves by diminishing our receipts? Is there anything a tariff can do, which an earthquake could not do better?"*[2]

General equilibrium modes suggest that should tariff reductions cause a loss of employment from a protected industry, then it can be expected that this labour would be absorbed into other sectors of the economy that have not previously been able to increase output due to a lack of appropriate resources.

There is a role that the government can play here in co-ordinating and facilitating this employment adjustment process, for example through assisting and retraining displaced labour. But it should not try to prevent structural adjustment.

Efficiency Considerations

Allocative efficiency occurs when an economy's resources are fully employed in a manner that yields maximum economic benefit. A key specification of this state of efficiency is that prices in the economy are set to reflect underlying costs. Tariffs prevent this from happening by driving a wedge between prices and costs.

A tariff artificially raises the price of the imported good, which allows domestic producers to set their price at a higher level without becoming uncompetitive relative to imports. This has key distorting effects on the domestic economy.

The price of the imported good and its locally produced substitutes are increased. Revenue is also generated for the government and a disincentive to export is created for the protected industry, as it receives a higher price in the domestic market than on the world market.

These distortions have flow-on affects in the economy. The higher domestic prices caused by the tariff eat into disposable incomes which in turn reduce demand in industries unrelated to the protected sector. Terms-of-trade adjusted GDP falls, because the economy must export higher volumes to purchase the same amount of imports.

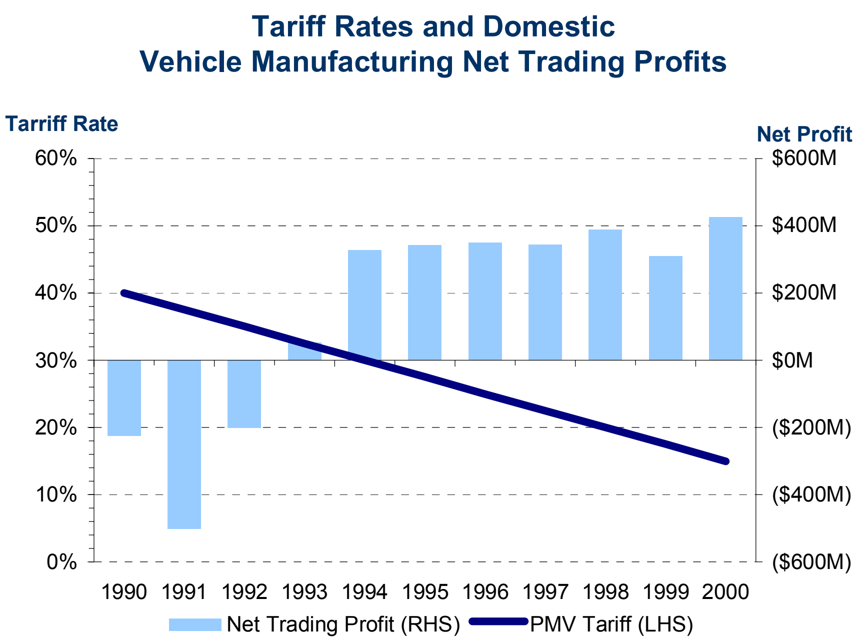
The tariff adversely affects the economy at a micro level, as the higher domestic prices place upward pressure on nominal earnings as employers move to conserve the real value of wages. Added to this is the fact that employers are forced to pay more for imported inputs and inputs from the protected domestic industry. Hence wage costs and the prices of inputs in the economy are forced up.

In turn, higher labour and input costs would be reflected in a higher price for the final good or service. The case is much worse for export businesses that are open to strong competition on the world market – they usually cannot pass on the higher costs.

Australia's strong economic performance over the past decade – particularly in the face of severe downturn in its major export markets in 1997-98 and 2001- is testimony to the greater flexibility and resilience which more than a decade of economic reform has helped to build. Trade liberalisation and tariff reform have been an important part of that process, and as Australia moves (it is to be hoped) towards a zero manufacturing tariff regime by 2010, the pockets of sectoral protectionism in motor vehicles and textiles, clothing and footwear appear increasingly anachronistic.

It is true that, as tariffs have steadily reduced, the net gains from implementing further reforms become proportionally smaller. But so do the costs to those businesses likely to be disadvantaged by further reform. Indeed, as the evidence on the following pages attests, the industry's performance has improved steadily on most key measures throughout the period when tariffs were reducing. This is not a coincidence – it is testimony to the 'cold shower' benefits of increased competition on the performance even of formerly protected industries.

Figure 1



Source: Department of Industry, Science & Resources

3. TARIFF REDUCTIONS AND THE AUTOMOTIVE INDUSTRY

This section examines evidence on the economic performance of the domestic passenger motor vehicle manufacturing sector. The analysis suggests that the passenger motor vehicle manufacturing industry is now economically mature, and well able to cope with declining protection.

Profitability

Figure 1 shows the net trading profit of local passenger motor vehicle manufacturers against the pattern of tariff reduction since 1990.

It shows that despite tariff reductions, the passenger motor vehicle manufactures sector moved from net losses to profits in the second half of the decade. In the late 1990s profits were fairly stable, reaching high of $427 million in 2000 representing a 5.1 per cent return on sales.

While many factors besides the tariff rate can affect profitability, it is clear that, at the very least, any negative effects on profitability arising from tariff reductions in the late 1990s have been more than offset by other factors

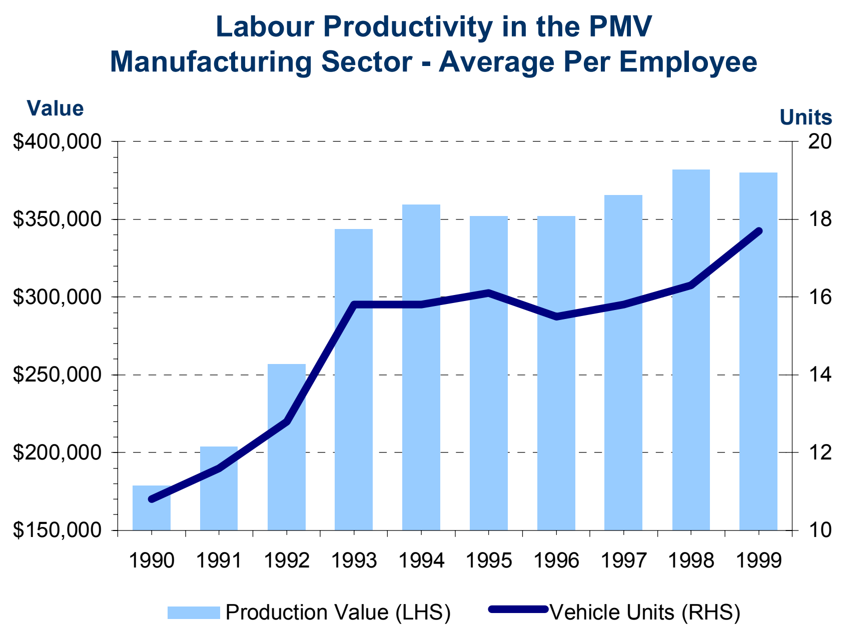
Employment and Productivity

Employment in the industry declined over the mid 1990s but has levelled off at the end of the decade to average just below 20,000 since the low of 19,754 reached in 1995. From this, there is evidence to suggest a relationship between reducing tariffs and falling employment within the sector.

From 1991 employment fell at an average of 4.3 per cent each year, which was steeper than the trend in employment within the manufacturing sector as a whole, which declined an average of 0.3 per cent per annum.

With falling employment and rising output, productivity in passenger motor vehicle

Figure 2



Source: Department of Industry, Science & Resources

manufacture has showed steady growth since 1990 (Figure 2) with the number of vehicles produced per employee and the value of production per employee both showing a general growth trend.

Figure 3 shows that aggregate production volumes and production values have generally risen over this period, suggesting that the reductions in employment may have come as a result of structural changes within the sector (i.e. increased mechanisation) rather than increased exposure to competition by way of the falling tariff rate.

Australian Market Shares

Figure 9 shows the sales market share of domestically produced passenger motor vehicle by market segment.

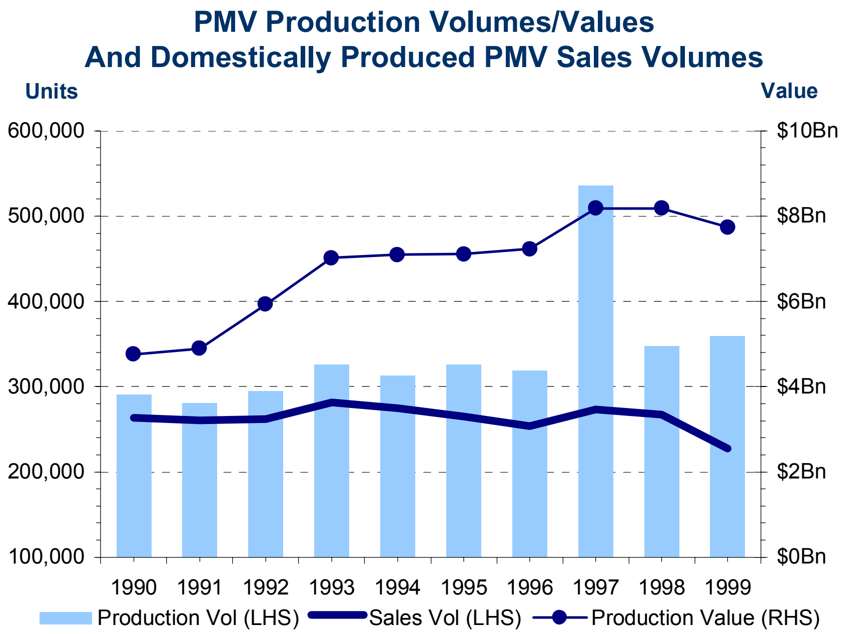
The market share of locally produced passenger motor vehicles across all segments has declined in general over the past decade. Overall market share of local passenger motor vehicles stood at 41.1 per cent in 2000 compared with a share of nearly 69 per cent in 1990.

Small Cars

Australian-made passenger motor vehicle sales in the small car market have shown the largest decline since 1990, with manufacturers moving production of these vehicles overseas during this period. Nissan was the first to axe Australian small car operations in 1992 when it ceased all its Australian passenger motor vehicle production. In 1994 Ford ceased its small car operations and finally, the Toyota Corolla was the last small car manufactured in Australia, with production ceasing in 1999.

This market shift has allowed the industry to rationalise, to concentrate production in its area of competitive advantage and to reduce the number of models produced, but it has come at a price. National demand has tended to shift towards the purchase of smaller vehicles – itself an effect of the removal of tariff and other barriers, which once fell disproportionately heavily on small car imports. Other policy-induced changes to product, income and fringe benefits taxes may also have affected this shift.

Figure 3



Source: Department of Industry, Science & Resources

In 1990 private sales of small cars in Australia accounted for 46 per cent of total private passenger motor vehicle sales. In 2000 private small car sales made up almost 64 per cent of total private sales. In 2000, 190,418 small cars were sold privately, representing an increase of 62.5 per cent from 1990 (Figure 4).

Medium-Sized Cars

In the medium car market, domestically-produced vehicles have steadily lost market share since the early 1990s.

Since 1990, the locally produced share of sales in this market has averaged approximately 68 per cent, and in 2000 total sales of locally produced medium vehicles were 62 per cent lower than in 1990.

In the early 1990s most local production in this vehicle category was of the Mitsubishi Magna and Toyota Camry/Apollo. However, most of the decline seen in the domestic medium car market comes as a result of the boom in the small car market and the move towards more powerful six cylinder engines for the Magna, Camry and Apollo.

In 1990 the Magna was the largest domestically produced medium car, but by 2000 it was classed purely as a large vehicle, available only in six cylinder engine capacities.

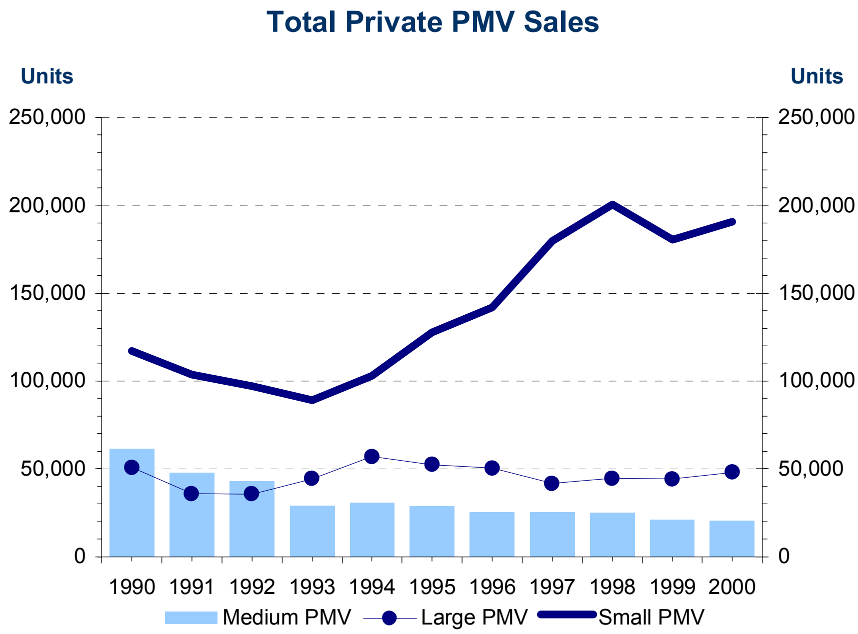
The decline in the medium car market has been matched with a rise in sales of domestically produced large cars, most notably the Magna and Camry/Apollo.

Large Cars

The large car market has been the main focus of domestic passenger motor vehicle manufacturing and over the ten years from 1990 to 2000 has enjoyed an average sales market share of 97 per cent.

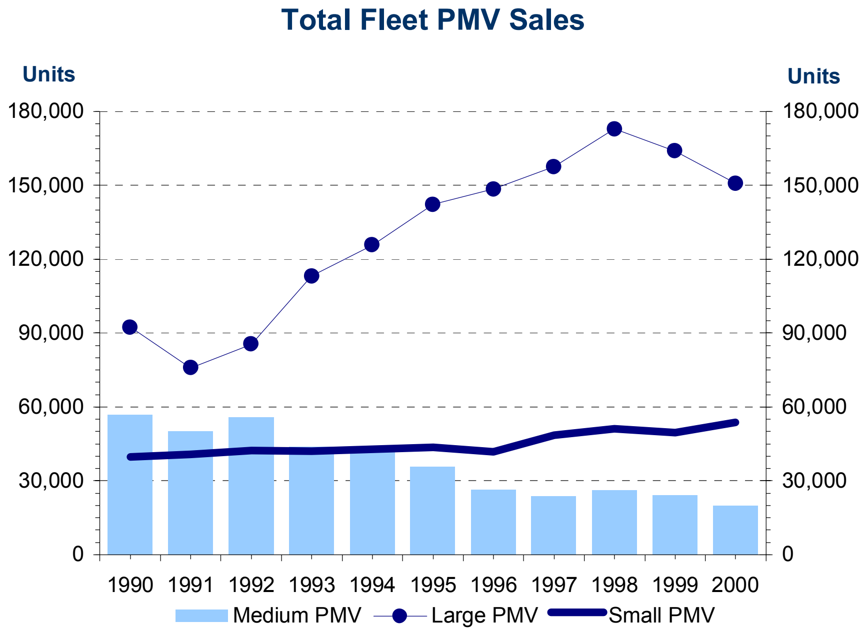
In 2000, total sales of locally-produced large cars registered 192,790 units, almost 46 per cent higher than in 1990, with sales peaking in 1998 at over 214,000 units.

Figure 4



Source: Department of Industry, Science & Resources

Figure 5

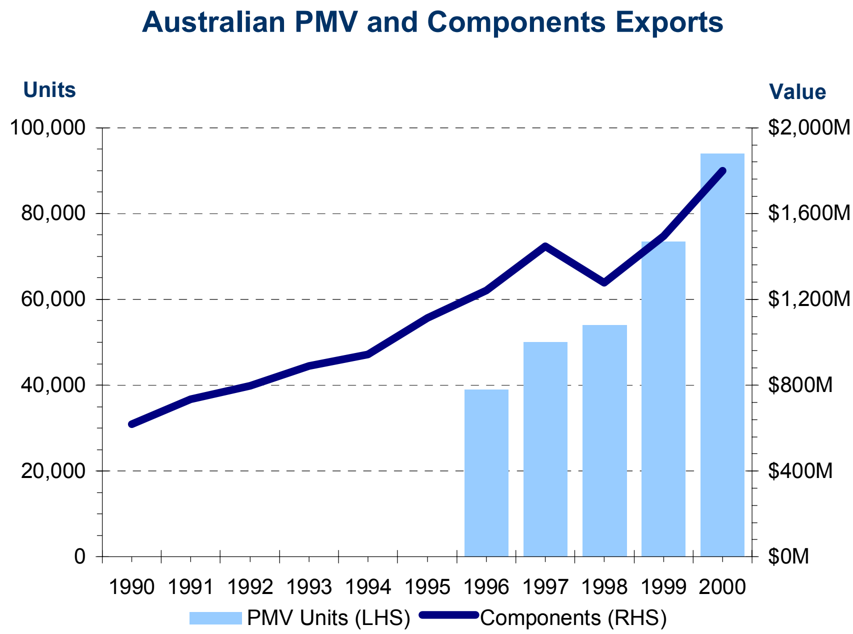


Source: Department of Industry, Science & Resources

The strength of the locally-produced large passenger motor vehicle is partly reflected in fleet sales. From 1990 to 2000 Australian fleet sales grew by 20.5 per cent, and over this same period the percentage share of large fleet car sales increased from 44 per cent in 1990 to almost 60 per cent in 2000 (Figure 5).

Australian sales are more heavily skewed towards large cars than most economies around the world, perhaps reflecting tax effects including comparatively low fuel taxes and the impact of Fringe Benefits Tax on demand.

Figure 6



Source: Department of Industry, Science & Resources

Exports

Australian exports of passenger motor vehicle and their component parts have grown strongly (Figure 6), particularly to the Middle East. The value of exports to this destination in 1996 accounted for just 5.5 per cent of Australian passenger motor vehicle and component exports, compared to a share of 31 per cent in 2000.

Passenger motor vehicle exports were led by the Toyota's Camry export program to the Middle East and the success of the Mitsubishi Magna on the international market.

South Korea has been an important importer of Australian components since the mid 1990s and in 2000 North America was the second-largest export market for passenger motor vehicles and component parts. The growth in exports within this sector is a positive sign that the industry is improving its efficiency and adjusting to international competition.

Summary

Statistics on key indicators within the passenger motor vehicle manufacturing sector would suggest that the industry has performed well in the face of falling rates of tariff protection.

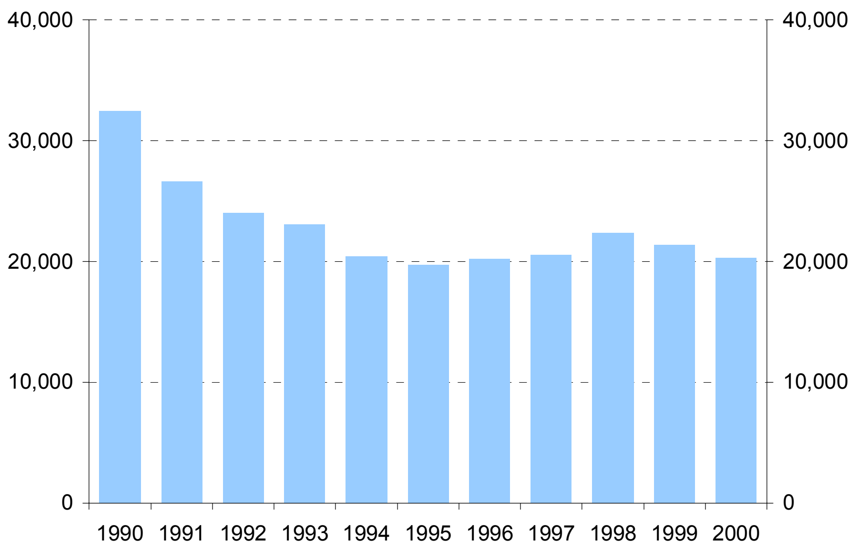
In looking at such statistics, however, it is incorrect to merely conclude that the sector has performed satisfactorily without taxpayer assistance, as other forms of subsidy have benefited industry participants. Most notable are the Automotive Competitiveness and Investment Scheme (ACIS), the Automotive Market Access and Development Scheme and the preferential treatment of locally produced vehicles under fleet arrangements.

The merits (or otherwise) of these assistance programs are not of primary concern in this review. It is worth noting however, that even if tariff protection were completely eliminated, this sector would still receive more generous assistance than most manufacturing sectors, let alone other industries.

This would be more evident still if the indirect benefits from distortions to demand from measures such as Fringe Benefits Tax, which encourage the provision of relatively large vehicles as benefits, were taken into account.

Figure 7

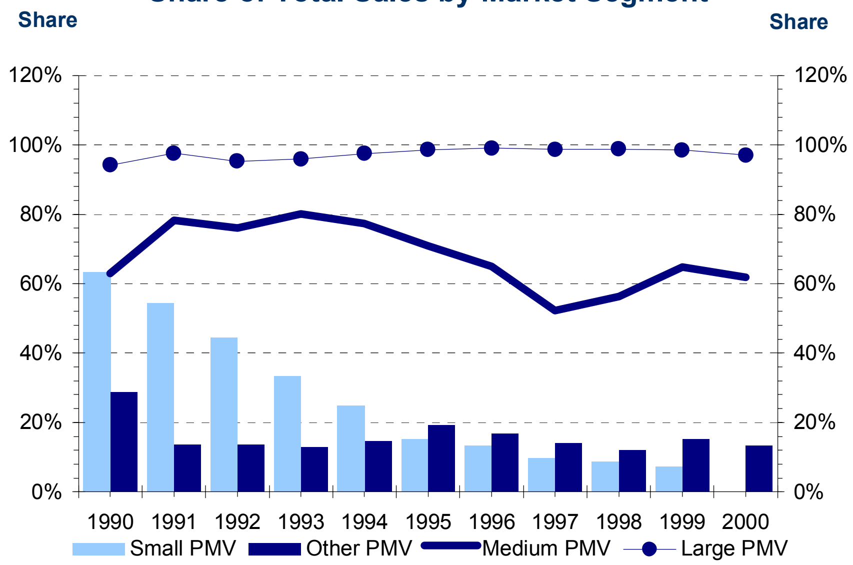
Employment in the PMV Manufacturing Sector



Source: Department of Industry, Science & Resources

Figure 9

Locally Produced PMV
Share of Total Sales by Market Segment



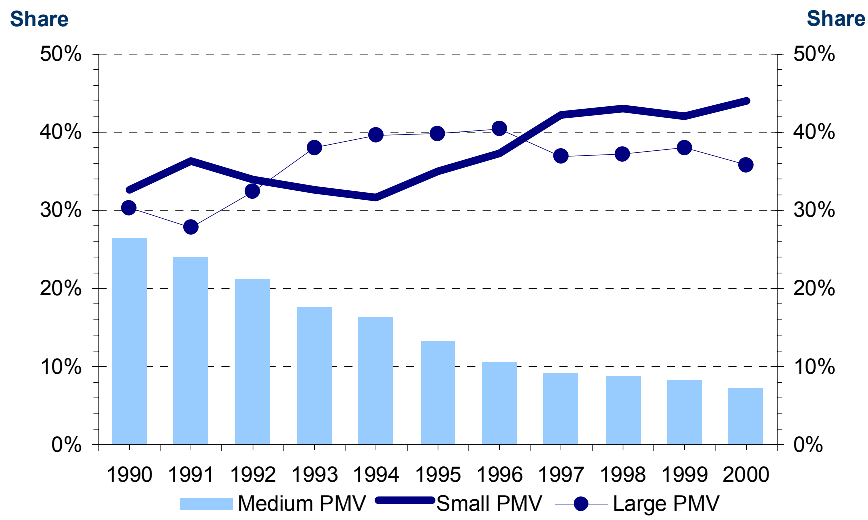
Source: Department of Industry, Science & Resources

Further, the different forms of assistance and protection are sometimes related – for example assistance given under ACIS is tied to the tariff rate, so over the past decade, this level of support has been reducing.

Aside from this, it is evident that the pattern of domestic demand has played a key role in determining the success of the local automotive manufacturing industry. The shift to small cars in the private domestic market became apparent in 1995-96, by which time most small car manufacture had been moved overseas.

Figure 8

Total New PMV Sales Shares by
Market Segment



Source: Department of Industry, Science & Resources

While locally produced passenger motor vehicles, unaffected by tariff rates, have dominated the large car market over this time, the growth in this segment has been offset by the surge in the import-driven small car segment.

This has resulted in domestic producers losing their overall market shares, but regaining profitability.

With the exception of Nissan, which moved all operations overseas, passenger motor vehicle manufacturers have continued production in Australia in the medium and large segments.

Nonetheless, it is evident that the automotive manufacturing industry has benefited from the assistance it has received in the past and its performance in recent years has proved it will remain viable in an environment of continuing trade liberalisation.

4. INTERNATIONAL TRADE POLICY CONSIDERATIONS

At the forefront of Australia's trade policy commitments is the APEC Leaders' Declaration of Common Resolve made in the 1994 Bogor meeting in Indonesia. The declaration affirms participants' commitment to achieve free and open trade and investment in the Asia Pacific no later than the year 2020, with the industrialised economies achieving the goal no later than the year 2010[4].

The Bogor declaration highlights the interdependence of economies in the Asia Pacific region and emphasises the role of industrialised countries in the progress of developing ones. The declaration urges industrialised economies to "*provide opportunities for developing economies to increase further their economic growth and their level of development*".

It is important that Australia works toward this goal of free and open trade and investment by 2010, and the diminution of trade barriers to the domestic automotive manufacturing industry is a key policy objective in this context.

Australia's efforts and co-operation towards achieving this goal will prove it as a responsible industrialised country in affording opportunities to developing countries. However the pursuit of trade liberalisation in this instance need not be a purely sacrificial act for Australia, as honouring the declaration would certainly provide the government with a higher degree of integrity and influence in future bilateral and multilateral trade negotiations, as well as benefiting the Australian community as a whole through lower prices and improved efficiency.

The AFTA-CER task force reporting in October 2000 also raised the possibility of a closer economic partnership between the Australia and New Zealand Closer Economic Relations Trade Agreement (CER) and the ASEAN Free Trade Area (AFTA). Its report affirmed the value of closer economic integration between the two groups and identified a wide range of benefits that would flow from this, including welfare gains to consumers, increasing the region's competitiveness and attractiveness to investment and strengthening its bargaining power in multilateral negotiations[5].

While a strict free trade agreement was not reached, further trade liberalisation efforts would strengthen the partnership between Australia and its Asian trading partners. According to the Department of Foreign Affairs and Trade, merchandise trade with ASEAN accounted for 14 per cent of Australian trade in 2000-01 and further trade liberalisation efforts would build on these key trade partnerships.

5. CONCLUDING COMMENTS

The remnants of protectionism in Australia's vehicle and textile industries are smaller and less economically damaging than in the 1970s and 1980s, and in the context of a much reduced general level of manufacturing tariffs, attract less controversy and attention than they once did.

They remain nonetheless a net cost to the Australian community, representing an unnecessary and unjustified transfer of benefits from the consumers and unprotected producers to a narrow and geographically concentrated set of beneficiaries. Although these costs are less than they once were, they still act to the detriment of consumers' living standards and exporters' competitiveness.

There seems little evidence to suggest that the sector needs such protection.

The benefits it might confer are swamped by the effects of inescapable changes in the wider market environment, for example those induced by for example exchange rate movements.

Furthermore, to the extent that a case for government support for this industry could be made, it appears that the other assistance and incentives provided to this sector compare generously with other manufacturing sectors, let alone other industries outside of manufacturing.

Indeed, the trends in the sector's performance across many indicators over the past decade suggests that, at the very least, it has improved in spite of the reduction in tariff protection. It might even be argued that it has improved because of the 'cold shower' effects on competitiveness and the incentive to improve efficiency of removing protection, particularly in areas such as exports.

Maintaining relatively high tariffs in this sector may act to undermine Australia's credibility as a proponent of trade liberalisation in international trade forums and negotiations. If so, it could do far more damage to Australians' interests than the direct costs of deadweight losses and impaired efficiency and competitiveness.

Nowadays, Australia no longer imposes significantly higher manufacturing tariffs than most of its major trading partners. This means that, in future, the greatest gains from trade liberalisation are likely to come from negotiating access to overseas markets for Australia's exporters, whereas in the past 30 years the greatest gains from trade policy accrued from reducing the self-inflicted damage imposed on the Australian community by domestic protectionism.

Some commentators argue that the increasing importance of reducing our trading partners' trade barriers constitutes an argument for Australia retaining it residual tariffs as bargaining chips. CCI disagrees.

We addressed this issue of reciprocity in our response to the industry commission's draft report into the automotive industry in 1997, and have had no cause to change our views:

> *"To some extent the argument about reciprocity or unilateralism comes down to whether Australia can achieve most by inducement or by example. Reciprocity assumes that Australia's trading partners have sufficient to gain from reductions in Australia's tariffs to induce them to change their own trade policies if we offer to change ours. But this seems to be based on an unrealistic assessment of the influence which Australia can exert on its trading partners. The USA or Japan might persuade their trading partners to change protection levels by the threat or inducement of changes in their own policies; but Australia accounts for a minor share of most of its*

> *trading partners' export markets, and is unlikely to have the same leverage. New Zealand and Korea are the only countries for which Australia is a major export market, and we already have a free trade agreement with New Zealand.*
>
> *"An alternative view which is at least equally plausible is that operating as the voice of reason in international forums (as Australia has done in APEC and WTO/GATT negotiations), or even leading by example, might also influence our trading partners' behaviour.*
>
> *"Realistically, whether Australia cuts, keeps or argues against tariffs is unlikely to exert a major influence on other countries' protection policies. We are not likely to achieve much by either inducement or example."*

This debate must also be seen in the context of Australia's commitment to achieve zero tariffs by 2010. Assuming that commitment is to be met – and CCI is firmly of the view that it should – then maintaining relatively high tariffs beyond 2005 will only defer the inevitable, and force a more rapid transition to zero tariffs at the end of the decade than would otherwise have been the case.

In summary CCI supports the following courses of action:

- That the Government continue to press for reductions in the tariff and other trade barriers implemented by Australia's current and potential trading partners.
- That the tariff on passenger motor vehicles continue to reduce beyond the 10 per cent level scheduled for 2005, to a point where it matches the general manufacturing tariff rate.
- That the general manufacturing tariff (including tariffs on passenger motor vehicle and light commercial vehicles) be reduced to nil by 2010, as agreed under the 1994 APEC Leaders' Declaration of Common Resolve.

6. REFERENCES

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