COMMENT ON PRODUCTIVITY COMMISSION POSITION PAPER: *REVIEW OF AUTOMOTIVE ASSISTANCE*[1]

Background

The Australian auto industry has made considerable progress since the days of protectionism in the mid-1980s. The tariff rate applying to passenger motor vehicles (PMVs) imported into Australia has been phased down from 35% in 1992 to 15% today, and is scheduled to be reduced further to 10% in 2005.

While the future potential reductions in assistance are minor compared to those achieved in the past, there are still likely to be positive benefits for the Australian economy from reducing assistance to the PMV industry. The Productivity Commission has estimated that the consumer tax equivalent of Commonwealth auto industry assistance was $1.9 billion in 2001. The burden falls particularly heavily on export-oriented States such as Western Australia. Removing this burden from the remainder of the economy would generate substantial benefits for the nation.

The Economy-wide Cost of Tariffs

The Productivity Commission's Position Paper analysis examines the economy-wide impact of the PMV assistance measures (the PMV tariff and the Automotive Competitiveness and Investment Scheme or ACIS) on the entire Australian economy. While there is no question that a tariff or subsidy will raise production, and most likely employment, in the protected industry, there should be general acceptance that the imposition of a tariff on a particular industry imposes significant economy-wide costs on the entire country.

As the report highlights tariff directly transfers money from consumers (including other businesses) to domestic producers and the Government. Additionally, it transfers resources from the producers of other goods and services to producers of the protected industry. This transfer of production from relatively efficient (often export-orientated) industries to the relatively inefficient protected industry, lowering the total output, and hence welfare, of the entire economy.

It is noted that, under some assumptions, the modelling of the economy-wide impacts presented in the Position Paper identifies some scenarios were the removal of PMV assistance might reduce the welfare of Australian residents. However these results rely on assumptions we consider unrealistic. These concerns are outlined in the Appendix.

[1] These are comments provided by the Western Australian Department of Treasury and Finance and do not necessarily reflect the views of the Western Australian Government.

Overall, the presence of a tariff on PMVs greater than the general rate of tariffs, and the operation of the ACIS, are detrimental to output and welfare in the Australian economy as a whole.

Regional Impacts

The Australian PMV manufacturing industry is largely centred in Victoria and South Australia. Western Australia, in contrast, has no PMV manufacturing capacity, but a very large share of export orientated mining and agriculture industries. In 2000-01, mining (excluding mineral processing) accounted for 23% of Western Australia's gross State product (GSP), compared with 4.6% nationally and the agriculture, forestry and fishing industry accounted for 4.1% (compared with 3.0% nationally). Western Australia's merchandise exports accounted for 26% of the nation's merchandise exports, despite Western Australia's real GSP accounting for only 10.6% of the national total.

As a highly export-oriented economy, Western Australia has borne a larger than proportional share of the costs imposed by PMV assistance measures. Both Productivity Commission and Econtech modelling found reducing PMV assistance was positive for employment and output (Econtech only) for the Western Australian, New South Wales (except the Illawarra region), Queensland, Tasmanian, Northern Territory and ACT economies.

Importantly, in both analyses, Australia's non-metropolitan regions, which produce much of our resource and agricultural exports are some of biggest beneficiaries from PMV assistance reduction. In some scenarios, regions within Victoria and South Australia are also beneficiaries from reform.

Additionally, Western Australia, and Australia generally, benefits from a relatively free and open international trading environment. The PMV tariff imposes costs on our trading partners, damaging our own commitment to free trade and reducing our bargaining position with other countries which we want to reduce their trade barriers.

Clearly, leaving the PMV tariff unchanged will unfairly penalise Western Australia (and other states) relative to Victoria and South Australia. Tariffs hold back Western Australia's world-class mining and mineral processing and agriculture industries, which is to the detriment of Australia as a whole.

The interstate transfers imposed under the national PMV tariff arrangements add to the (approximately) $3.0 billion per annum net fiscal subsidy that Western Australia provides to the rest of the Federation through Commonwealth fiscal policies.

Arguments for Protection

The Australian PMV manufacturing industry has used several arguments to justify the protection imposed. This section lists these arguments and analyses each.

The Car Industry is an Important Producer and Employer in the Australian Economy.

The industry claims that it is a significant producer and employer in the Australian economy. This argument misses the point in that policy should be directed at maximising employment and total output from all industries in Australia, as the Productivity Commission's analysis has done. If PMV tariffs promote production and employment in the PMV at the expense of other industries for a net loss to the total Australian economy, then it is bad policy.

In any event, the PMV industry accounts for only 1% of Australian gross domestic product (GDP)[2] and only 0.54% (50,000 people)[3] of total Australian employment. This compares to Agriculture, Forestry and Fishing which contributes approximately 3% of GDP[4] and employs 435,000[5] people or the mining and mineral processing industry[6] which accounts for 8.8% of GDP and employs 393,000 people. Both are export-orientated industries that are likely to be hurt by the PMV tariff.

The Increase in Economy-wide Costs due to Tariffs is not Significant

The industry might claim that a 10% PMV tariff rate, a low level compared to the past (the PMV tariff was 35% in 1992), has an impact on the entire economy that is small relative to the potential cost of losing a car manufacturer from the country.

While the potential gains to the economy from reducing the PMV tariff rate are small compared to gains from previous reductions, they are real and worth pursuing.

The PMV manufacturing industry's support for the ACIS, which is based on import duty credits, scheme is an implicit admission of the cost of automotive tariffs on the economy.

Other Countries Protect their Automobile Industries

Often, it is argued that Australia must protect its PMV manufacturing industry because other countries protect their industries.

There are, however, significant benefits to Australia from unilaterally reducing its PMV tariff rate. This is because it makes little sense to encourage resources into a low return industry (PMVs) from high return industries, as this will cause total output to fall.

The net impact of foreign government intervention in the worldwide PMV industry is usually to depress Australian PMV industry returns. Imposing a higher rate of PMV tariff in response therefore encourages resources into an even lower return industry, which in turn imposes an even greater cost to the Australian economy. It does not matter whether returns to the Australian industry fall due to interference by other governments, or due to a cost reducing technology in an overseas manufacturer, the net impact is the same. The burden of assistance falls on Australian consumers.

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[2] South Australian Government (2002), Submission to the Productivity Commission Post 2005 Assistance Arrangements.
[3] South Australian Government (2002), Submission to the Productivity Commission Post 2005 Assistance Arrangements, ABS Cat. No. 6202.0.
[4] ABS Cat. No. 5204.
[5] ABS Cat. No. 6291.0.
[6] Consists of the mining (ABS industries 110-152), petroleum, coal and chemical (25), non-metallic mineral products (26) and the metallic mineral products (27) industries.

Additional Factors Influencing the PMV Industry Relevant to the Debate

Since the previous review of automotive assistance in 1997, there have been several developments and trends that have either favoured the Australian PMV manufacturing industry or are adversely affecting the industry irrespective of the level of tariffs. In any event, the justification for maintaining the PMV tariff at 10% is reduced by these trends, which are detailed below.

Change in Consumer Tastes

In 1997, the Productivity Commission noted that a change in consumer tastes was the major reason for a shift towards imported automobiles, not any reduction in tariff levels.

Australia's motor vehicle production industry specialises in the production of "large" passenger motor vehicles such as the Holden Commodore, Ford Falcon, Mitsubishi Magna and the Toyota Camry six cylinder/Vienta. The industry also produces the Toyota Camry and Holden Vectra in the "medium" car category. The local industry does not produce a car in the "small" category (the last was the Toyota Corolla, of which Toyota ceased Australian production in 1999[7]).

Consumers, however, are increasingly demanding smaller cars rather than the large family sedans produced by Australian manufacturers. In the 1997 inquiry into automotive assistance, the Productivity Commission found that changes in consumer tastes was the major factor in Australian producers losing market share to imports, not the removal of automotive tariffs over the previous decade.

This trend has continued since that inquiry. In 2000, small cars accounted for 44.1% of all automobile sales in Australia[8], up from 35.1% in 1995. Large cars accounted for 36.9% of automobile sales in Australia in 2000, down from 39.8% in 1995.

The trend was much more evident in private sales of automobiles, where sales of small vehicles increased from 53.2% of all private sales in 1995 to 63.8% in 2000. Fleet (business and government) sales tended to favour large vehicles, and purchased 59.1% of their vehicles in this category, up from 57.2% in 1995.

The implications of these data are twofold. Firstly, business and governments (through fleet sales) are increasingly bearing the direct cost of PMV industry protection rather than consumers. This has serious implications for Australia's international competitiveness.

Secondly, the trend towards smaller PMVs, driven by lifestyle and fuel economy considerations, is likely to continue no matter what the relative price difference between the two. The market for large family cars is the domain of the Australian producers. The maintenance of the current PMV tariff rate after 2010 is unlikely to help the Australian PMV industry to a great extent.

Improvement in Productivity

The history of protected industries in Australia indicates that tariffs promote inefficiency.

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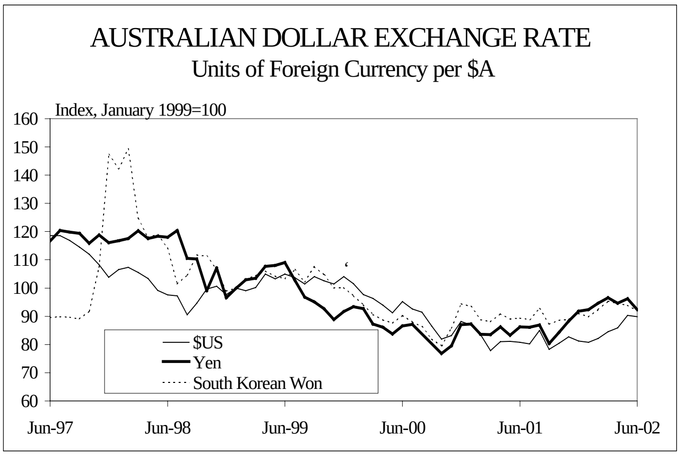
[7] The Department of Industry, Tourism and Resources, www.isr.gov.au/industry/auto.
[8] The Department of Industry, Tourism and Resources, www.isr.gov.au/industry/auto.

Conversely, the removal of tariffs from an industry will promote efficiency, and this appears to hold for the Australian PMV manufacturing industry. Since the 1997 inquiry, when the PMV tariff has been reduced from 22.5% to 15%, the average number of motor vehicles produced by an employee has risen from 15.5 in 1997 to 17.7 in 2000.

Reducing the PMV tariff from 10% to 5% will further promote efficiency in the industry, which will alleviate the negative impacts upon PMV industry profits to some degree and, more importantly, provide real benefits for the entire Australian economy.

Exchange Rate

The Australian dollar ($A) has depreciated considerably against the currencies of Australia's major suppliers of PMV imports (that is, imports have become substantially more expensive). In particular, since July 1997, the $A has lost 24% of its value against the United States dollar (as at 30 June 2002) and 23% of its value against the Japanese yen. Together, Japan and North America accounted for 64.2% of the value of Australian automotive imports in 2000.



Source: Reserve Bank of Australia Bulletin.

Additionally, the currency of Korea, which supplied 5.7% of Australia's automotive imports, has returned to its $A value of before the Asian financial crisis induced Won depreciation of 1997-98.

The implication of the depreciation of the Australian dollar against the currencies of the United States, Japan and Korea is that the Australian PMV industry now enjoys a considerably larger level of "natural" protection than in 1997. The price of imported cars has been raised by the depreciation of the Australian dollar[9] and so the reduction of the PMV tariff rate will be less damaging to the industry than in 1997.

There are a range of factors that influence the level of the Australian dollar, such as inflation, productivity and commodity prices, and there is no guarantee that the $A will not appreciate back to its levels of 1997. However, the depreciation of the $A since 1997 has provided PMV manufacturers with an increased level of natural protection.

9 Although the PCI motor vehicle index actually declined over this period (ABS), this seems to be due to the structural shift towards smaller (and hence cheaper) cars and the replacement of the wholesale sales tax with the goods and services tax in 2000.

Introduction of the GST

In July 2000, the Commonwealth Government replaced the 22% wholesale sales tax on motor vehicles with the 10% goods and services tax (GST). The Commonwealth Government estimated that the price of PMVs would fall by 8.3% under the new taxation arrangements, compared to a 4.4% rise in the general price level[10].

While the transition to the GST caused considerable disruption in the sales pattern of PMVs, the change has reduced the price of PMVs substantially relative to the general price level, making PMVs more attractive to consumers and lessening the need for support.

Conclusion

In summary, the presence of a tariff on PMVs greater than the general rate of tariffs, and the operation of the ACIS, are detrimental to output and welfare in the Australian economy as a whole.

As the productivity Commission Position Paper indicates, Western Australia is particularly badly affected because its economy has no PMV manufacturing but a much larger share of export-orientated mining and agricultural industries than other States. These industries bear the increased costs imposed by a tariff but are unable to increase their output prices above the prevailing world price for each commodity.

Arguments used by the PMV manufacturing industry to justify support are not valid if the impact of the assistance on the entire Australian economy is considered. In any event, the PMV manufacturing industry is a relatively small producer and employer compared to total Australian GDP and employment.

We therefore share the view of the Productivity Commission that maintaining assistance at 2005 levels for an indefinite period is not a sensible option. Furthermore, those assistance measures for the Australian automotive industry should be removed as quickly as possible.

To this end, the PMV tariff should be reduced to 5% by 2010, and then further reduced with any change in the general rate of tariffs. The phased reduction of 1% per annum is the most attractive option, as benefits from the tariff reduction will be felt before 2010.

The ACIS is also distortionary and likely to reduce national welfare. The ACIS scheme does have a role as an adjustment mechanism in the transition of the automotive industry to unprotected status. This adjustment process, however, should not be an indefinite period, and the ACIS scheme should be phased out by 2015.

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[10] *Tax Reform; not a new tax; a new tax system*, Circulated by the Honourable Peter Costello, M.P., Treasurer of Australia, August 1998.

APPENDIX: MODELLING ASSUMPTIONS

An important consideration in determining the net benefits of PMV manufacturing assistance reduction is the "terms of trade" effect mentioned in the Position Paper, where any expansion in production of Australia's export-orientated industries after the reduction in a tariff must be sold at a lower price to clear the expanded output.

Both Productivity Commission (using the MONASH Model) and Econtech (using its MM600+ model) modelling show that, under certain export elasticity assumptions, removing PMV assistance arrangements might reduce the welfare of Australian residents. In these cases, the negative impact from the terms of trade affect outweighs the positive impact of the resource allocation effect.

These results, however, rely on assumptions that we consider to be unrealistic. In particular, the export elasticities in the base case are too low and inconsistent with Australia's status as a small open economy. As Econtech notes "models such as MM600+ arguably understate export price elasticities of demand to avoid model solution complexities"[11]. Productivity Commission simulations conducted under higher elasticity values show that reducing assistance to the PMV industry is unambiguously positive (in the long run) for the Australian economy.

Secondly, both analyses assume that the real wealth of Australians is unchanged between the "with" and "without" assistance scenarios. While this might have intuitive appeal in that consumption can then be regarded as an unambiguous measure of welfare[12], it arguably understates the economic gains from reform.

In particular, because real wages increase (as employment is fixed), Productivity Commission modelling notes that "Australia's capital stock can only increase if it is financed by foreigners"[13]. Domestic investors are not able to invest and gain capital income from the opportunities created by the reduction in auto assistance.

The implications of this assumption are not totally spelt out in the Productivity Commission's modelling, but it is likely to reduce the overall benefits from reform.

Similarly, Econtech's analysis assumes that private sector saving is fixed because, in a long-run comparative static framework, it considers that standard long run assumptions overestimate the benefits of reform. For example, it notes that "the model results show the gain in future consumption but not the sacrifice in current consumption"[14]. In our view, this is an inappropriate assumption to deal with the problem, which could have been examined in a short-run simulation, and leads to an understatement of the true benefits of PMV assistance reduction.

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[11] Econtech (2002), *Economic Modelling of the Post-2005 Assistance Arrangements for the Automotive Manufacturing Sector*, page 17.

[12] Productivity Commission (2002), MONASH Modelling of Post 2005 Assistance Options for PMVs, page 5.

[13] Productivity Commission (2002), MONASH Modelling of Post 2005 Assistance Options for PMVs, page 6.

[14] Econtech (2002), *Economic Modelling of the Post-2005 Assistance Arrangements for the Automotive Manufacturing Sector*, page 5.