South Australian Government Response to the Productivity Commission

on

Post 2005 Assistance Arrangements for the Automotive Manufacturing Sector

August 2002

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Executive Summary

The Government of South Australia broadly welcomes the findings of the Productivity Commission in its report, *Review of Automotive Assistance: Position Paper*, released in June 2002. The report is constructive in its approach and addresses the major issues facing the automotive industry.

The Commission's support for continued assistance to the industry recognises the gains in competitiveness and productivity made by the sector while also identifying the significant challenges it faces as it becomes more globally integrated. It also recognises the sector's valuable contribution to the Australian economy – and to regional economies within South Australia and Victoria in particular.

In addition, maintenance of assistance recognises the industry's long lead times and its need for policy certainty in a highly competitive international environment for international investment. Long policy settings are highly desirable.[1] The Government of South Australia is particularly pleased to note the Commission's view that:

> "reducing remaining assistance too quickly after 2005 could put at risk production that might become internationally competitive in the longer term under a more gradual transition process. Given the industry's size, the costs to the community of unemployment and idle capital ensuing from 'unnecessary' adjustment could be substantial."[2]

This conclusion should drive decision making on future assistance to the industry.

The long-term goal of reducing assistance to the automotive industry to the level that is available to industry generally (and the manufacturing industry in particular) has merit. However, further changes to assistance levels should not occur until broadly comparable levels of assistance are provided to the automotive industry in other countries and progress has been made on market access.

Automotive Tariffs

The South Australian Government position on tariffs on passenger motor vehicles (PMVs) and some automotive components differs with that of the Commission. While South Australia agrees that the tariff on automotive products should be maintained at 10% from 2005 until 2010, it finds no reasonable case for a further reduction to 5% from 2010 to 2015.

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[1] Toyota Motor Corporation Australia, *Submission to Productivity Commission Inquiry into Post 2005 Assistance Arrangements for the Automotive Manufacturing Sector*, (May 2002): p54.

[2] Productivity Commission, *Review of Automotive Assistance: Position Paper*, (June 2002): pxxvii.

The tariff is an investment attraction device, and a timeframe which sees a 10% tariff in place until at least 2010 delivers an important message to global vehicle and components companies when making investment decisions. The automotive industry faces significant structural and technological change, which cannot be managed without a clear commitment from the Commonwealth Government to the sector within Australia. Australia's relatively modest assistance must continue so as to attract investment, which will assist in enhancing competitiveness in the sector. The symbolic value of a 10% tariff for investment attraction cannot be discounted.

Now is not the time to lock in further reductions beyond the reduction to 10% in 2005. The Productivity Commission has not adequately demonstrated any significant benefits of a proposed 5% tariff over a 10% tariff post 2005. In fact, as the Commission itself finds, such a reduction will provide negligible (even negative) gains to the community. Moreover, a 5% tariff, it can be argued, is equivalent to zero in its effectiveness and will provide the industry with little to no assistance for global integration. Neither the Australian community nor the sector will reap real benefits from any further cuts in the tariff rate below 10%.

Any future decreases in the tariff rate should be dependent upon a detailed assessment of the state of the automotive industry and market conditions, showing as a minimum:
- significant allocative efficiency gains to the Australian economy;
- the meeting of real improvements in global market access outcomes, including reductions in the levels of assistance provided to the automotive industry in other countries;
- a record of continual growth and investment in the South Australian automotive industry; and
- a clear indication that Australia has been positioned long-term as an attractive automotive investment destination by key global car and automotive component manufacturers.

An insistence on further tariff reductions fails to – and indeed cannot – properly take into account the prevailing conditions in 2010 and beyond and in particular the nature of the sector, the national economy and the global environment at that time. Any such decision would be peremptory.

The Commission has acknowledged that the industry receives substantial government support around the globe. At the same time, it contends that there has been reasonable progress in reducing automotive trade barriers. There is little evidence presented to support this argument. While Australia has engaged in largely unilateral reductions of its automotive assistance in the past, there has been no discernible impact on Australian access to overseas automotive markets as a result. The agenda of trade liberalisation can deliver significant benefits to Australian exporters and consumers, but it must be embraced in a considered and cautious manner, taking into consideration (among other things) the trade liberalisation agendas of other nations, particularly in the Asia Pacific region. Further unilateral liberalisation will ultimately deliver negligible benefits to the Australian community.

The South Australian Government therefore does not support any of the Productivity Commission’s three pre-determined options on the tariff.

Recommendation 1: The Government of South Australia recommends that automotive tariffs be retained at 10% after 2005, at least until 2010. Any further decision on tariff reductions at this time must be contingent upon a detailed assessment of the automotive industry and market conditions, showing as a minimum:

- significant allocative efficiency gains to the Australian economy;
- the meeting of real improvements in global market access outcomes, including reductions in the levels of assistance provided to the automotive industry in other countries;
- a record of continual growth and investment in the South Australian automotive industry; and
- a clear indication that Australia has been positioned long-term as an attractive automotive investment destination by key global car and automotive component manufacturers.

Any future tariff reductions below 10% should be implemented only after a full (and favourable) assessment of these key conditions has been undertaken in a process, which is fully consultative and transparent.

Automotive Competitiveness and Investment Scheme (ACIS)

The Commission supports the continuation of the Automotive Competitiveness and Investment Scheme (ACIS) beyond 2005 and has put forward three options for the scheme’s funding. The Government of South Australia welcomes the view that ACIS (or an equivalent) should continue beyond 2005 at least until 2010. The Government is of the view that current funding levels should be maintained in the five-year period from 2005 to 2010 (Option 1) in order to maintain the impetus for automotive investment in both plant and R&D, which is critical to the long-term viability of the industry.

ACIS should continue to promote investment, R&D and production within the industry. Although South Australia sees merit in the Commission’s assertion that significant change to the scheme would be unnecessarily disruptive, consideration should be given to more closely aligning the scheme’s outcomes with ensuring future growth and innovation within the industry. The scheme should maximise outcomes which promote the industry’s international competitiveness. Any changes to the scheme – including on capped and uncapped funding and on separate funding pools – should be determined in close consultation with industry.

The relative newness of the scheme (with only 18 months of operation) makes a full assessment of its success difficult at this time. However, initial evidence from industry participants and strong industry support (from both vehicle manufacturers and component producers) suggests it has successfully bolstered both investment and R&D. It has assisted the industry in taking up (and developing) new technologies and in building new plant, i.e. it has supported the growing competence of the sector. South Australia therefore supports the industry view of the efficacy of the program and its contribution to structural adjustment within the sector which will contribute to its long-term viability.

This process of adjustment is, however, not yet complete, and some elements of the sector are still on the road to international competitiveness. Withdrawal of the scheme in 2005 could have the effect of suddenly halting the structural changes now underway.

South Australia does not agree with the Commission's view that ACIS is purely a mechanism to support the industry during transition. In combination with the tariff, it is an important device to attract international investment into the sector and, as such, its lifespan and level of funding should be determined with investment attraction firmly in mind. Indeed, the argument for the scheme to continue is made stronger with the fall of the tariff to 10% in 2005. The tariff and ACIS are an integrated package for ensuring the long-term viability of the industry – important symbolically for investment decisions as well as in terms of real benefits. Any decision on the future of ACIS should be made in conjunction with policy decisions on the tariff.

Recommendation 2: The Government of South Australia recommends the continuation of ACIS (or its equivalent) at least until 2010. Any proposed changes to ACIS must reflect the need to promote factors that contribute to the automotive sector's growth and competitiveness in Australia, such as investment, research and development, innovation and increased production. Continuation of ACIS after 2010 should be assessed by the Commonwealth Government in consultation with industry, State and Territory Governments, and other key stakeholders.

Recommendation 3: Of the three options presented by the Commission on the funding of ACIS, the Government of South Australia has a preference for Option 1 – but any decision on the funding and timing of the scheme should be made in conjunction with decisions on the tariff.

Market Access

South Australia welcomes the Commission's acknowledgment that market access is a key issue for the sector (although the gains made to date have been less optimistic than the position paper would suggest) and its recognition that the Australian industry faces significant tariff and non-tariff barriers to export with its trading partners and with potential partners.

There is no evidence that Australia's commitment to leading the way in the APEC trade liberalisation agenda has improved market access for Australian automotive products. The 'demonstration effect' has no basis in reality.

The Government of South Australia continues to be disappointed with the market access outcomes achieved for Australian automotive products, particularly within the

Asian region. Following the 1997 Commission review, industry support for the reduction in automotive tariff was contingent upon the Commonwealth increasing its efforts to achieve gains in market access. However, there is little evidence that the promised market access gains have been achieved. Making headway on market access issues must be a critical factor in the determination of future policy on assistance to the industry, and in particular on tariff levels.

Recommendation 4: The Government of South Australia encourages the Commonwealth Government to redouble its efforts in achieving improved market access outcomes for automotive products through multilateral, regional and bilateral trade negotiations. It continues to be of the firm view that further reductions in automotive assistance should not take place in the absence of such progress.

Broader Adjustment

While the Commission has acknowledged the regional adjustment costs of any contraction in the automotive sector, the South Australian Government considers that it has understated these potential costs. South Australia and Victoria will be hardest hit by any contraction in the industry. For South Australia in particular, where the automotive industry is a proportionally larger contributor to the State economy, the issue of adjustment is of major importance.

Due to the nature of the automotive industry in particular (traditionally comprised of lower skilled and/or mature aged males) and its regional concentration in Adelaide's northern and southern suburbs, adjustment problems will potentially be significant and long term. As the Commission is aware, the northern and southern suburbs already record high levels of unemployment. A contraction in the automotive industry is likely to result in much higher levels of long-term unemployment in these areas.

It should be noted that while the Commonwealth Government has in the past implemented adjustment strategies, there has also been a significant budgetary burden on State and Territory Governments resulting from structural unemployment and associated social and economic costs. In the case of the automotive industry, this burden will disproportionately fall upon South Australia and Victoria. The Commonwealth Government therefore needs to be explicit in its commitment to any structural adjustment programs required.

Recommendation 5: The South Australian Government is dissatisfied with the Commission's assessment of the costs of regional adjustment in the automotive industry and believes that a more detailed analysis should be provided in its final report. In particular, the Commission should take into greater account regional studies presented to the current inquiry.

Summary of the South Australian Government Response

The following table details the South Australian Government's response to the individual findings of the Commission. The table also outlines further recommendations to the Commission on issues relating to the environment, safety, microeconomic reform, workplace relations and skilling, and other issues.

PRODUCTIVITY COMMISSION FINDINGS	SOUTH AUSTRALIAN GOVERNMENT RESPONSE
IMPACT OF AUTOMOTIVE ASSISTANCE	
Reductions in assistance to date have contributed to the rationalisation of the automotive industry and encouraged a stronger focus on export markets and higher productivity. Consumers and business users have benefited significantly.	True, but at the cost of considerable job losses and with domestic production now confined to a narrow segment of the domestic market (and with exports representing the only real growth prospects). Further reductions in assistance are unlikely to deliver gains of such magnitude in the future, given the current moderate levels of assistance. Losses have been offset by the depreciating dollar.
The automotive industry continues to receive tariff protection above the average for manufacturing as a whole and significantly greater budgetary assistance than any other sector. This has brought benefits to the industry, as well as some other activities. But it also imposes costs on the wider community, and in particular, consumers and business users of vehicles.	Tariff protection is currently supporting an industry which ranks as Australia's sixth largest exporter. Aside from budgetary support, the costs imposed on consumers and the wider community are trivial, at best.
The rationale for ACIS is to provide transitional support in the context of trade liberalisation. While it may have generated additional investment and R&D and is widely supported by the industry, the extent to which it will facilitate necessary adjustment is not easy to establish.	ACIS should continue to promote investment, R&D and production within the industry. Although South Australia sees merit in the Commission's assertion that significant change to the scheme would be unnecessarily disruptive, consideration should be given to more closely aligning the scheme's outcomes with ensuring future growth and innovation within the industry. The scheme should maximise outcomes which promote the industry's international competitiveness. Any should be made in consultation with industry in a process of broad and transparent consultation.
DIRECTIONS FOR FUTURE ASSISTANCE	
Assistance to the industry is now much lower than in the past. As a consequence, the 'allocative' gains likely to ensue from further assistance reductions would be commensurately smaller and 'dynamic' considerations assume greater significance. Thus, the policy calculus is now more complicated.	The allocative gains are not "commensurately smaller" — they are negative (on the Commission's own estimates contained in Appendix B). What are "commensurately smaller" are any remaining 'dynamic' gains — as local producers are now increasingly able to demonstrate that they are internationally competitive (by exporting with modest levels of

	assistance). Far from the policy calculus being now more complicated, it is clear that the bulk of gains from reducing assistance to the automotive industry have now been reaped on behalf of the Australian community.
While the automotive industry has special features these are not such as to warrant indefinite preferential treatment.	The long-term goal of reducing assistance to the automotive industry to the level that is available to industry generally (and the manufacturing industry in particular) has merit. However, further reductions in assistance should not occur until broadly comparable levels of assistance are provided to the automotive industry in other countries and progress has been made on market access.
Transitional costs are an important consideration in determining the rate of evolution to a longer term goal of removing special support.	Taking into account transitional costs is part of a proper assessment of whether there are net benefits associated with a particular policy proposal (in this case to further cutting assistance to the automotive industry). Any removal of assistance must be contingent on issues such as assessed benefits to the community, costs to regional economies within the nation, market access and impacts on production, innovation and export growth.
OPTIONS FOR POST 2005 ASSISTANCE	
Providing a clear and extended path for assistance policy would serve to reduce one source of uncertainty impacting on investment and production decisions. To this end, specification of a clearly defined assistance regime for the industry for the decade after 2005 is appropriate.	The South Australian Government supports this position in light of the long lead times and large investment decisions associated with the automotive manufacturing sector.
The Commission has identified three tariff options for reducing passenger vehicle tariffs to the general rate: *1. Reduce the tariff by 1% point a year commencing in 2006 so as to achieve a rate of 5% in 2010, with no further reductions before 2015.* *2. Leave the tariff at 10% until 2010 and then reduce it in one step to 5%, with no further reductions before 2015.* *3. Leave the tariff at 10% until 2010 and then reduce it by 1% point a year so as to achieve the rate of 5% in 2015.* *Of these options, the Commission sees benefits in option 2.*	The South Australian Government welcomes the continuation of a 10% tariff on passenger vehicles until 2010, but finds no reasonable case for a further reduction to 5% from 2010 to 2015. As the Commission itself finds, such a reduction will provide negligible (even negative) gains to the community. The effectiveness of a 5% tariff, it can be argued, is equivalent to a zero tariff and will provide the industry with little to no protection as transition and global integration continue.
The Commission sees a continuation of ACIS after 2005 as a means of facilitating a reduction in the tariff to 5%. However, it is still formulating its views on the merits of different rates and time profiles for ACIS funding after 2005. To stimulate public discussion, it has put forward the following indicative options. Each would involve an	The Government of South Australia welcomes the view that ACIS (or an equivalent) should continue beyond 2005 at least until 2010. The scheme should promote investment, R&D and production within the industry. South Australia supports full funding of the scheme from 2005 to 2010.

equivalent funding commitment in net present value terms. But the time profile, and therefore the notional dollar amount of funding, would vary in accordance with the three approaches outlined above: 1. *Funding of $2 billion to $2.8 billion, provided over five years, ceasing in 2010.* 2. *Funding with an equivalent net present value, provided over 10 years at a uniform rate, ceasing in 2015.* 3. *Funding with an equivalent net present value, provided over 10 years ceasing in 2015, with funding for the second five-year period set at half that for the first five-year period.* *To avoid imposing a disproportionate adjustment burden on any particular sector of the industry, the successor to ACIS could include separate capped funding pools for the vehicle producers and their suppliers. This change aside, there are considerable benefits in avoiding uncertainty associated with significant changes in scheme design.*	The future of ACIS after 2010 should be considered in consultation with industry and all stakeholders, including State and Territory Governments.
The $12 000 tariff on second hand vehicles, and government preferences for vehicles manufactured or sold by the local vehicle producers, would have no place in a totally free and open market environment. However, the potential benefits of their removal would appear at this stage not to warrant the additional uncertainty.	Agreed.
Acceptance by governments of the need to make more information publicly available on ad hoc *support provided to automotive (and other) firms would help to assure the community that such support was appropriate.*	The Government of South Australia accepts the need for transparency on a case-by-case basis where it is informed by commercial-in-confidence principles.
ADJUSTMENT ISSUES	
Further and continuing adjustment in the Australian automotive industry is inevitable and necessary.	Agreed, as outlined in South Australia's initial submission.
Implementation of the Commission's post 2005 assistance options would minimise the risk of significant industry-wide adjustment problems.	The issue of adjustment is not adequately detailed in the Commission's position paper. Its own modelling suggests that the impact of further reductions in assistance may be negative. Separate modelling of cuts to assistance provided by the Cities of Marion, Mitcham and Onkaparinga supports the view that adjustment, especially at the regional level, may in fact be profoundly negative.
Irrespective of what assistance arrangements are put in place after 2005, the possibility of potentially disruptive adjustment affecting individual firms and their employees and particular regions, cannot be ruled out.	Agreed. South Australian therefore recommends that the Commission's stated goal of removing special assistance be reviewed and that any reductions in assistance after 2010 be assessed at that time with a view to minimising disruptive adjustment effects.

The adjustment consequences of the exit of a vehicle producer would depend on a range of factors, including the exiting firm's export volumes and the degree of leakage of its domestic sales to imports. Some recent assessments of the impacts of the cessation of Mitsubishi's manufacturing operations in Australia may have overstated the likely consequent reduction in total production volumes in the industry. *Firm or regional-specific adjustment assistance could be warranted if firm exits have the potential to cause major disruption. However, as well as facilitating necessary change, any such assistance should:* - *target individuals for whom adjustment pressures are most acute and who are unlikely to be able to cope without additional assistance;* - *be of limited duration so as encourage transition;* - *be simple to administer; and - be compatible with general 'safety net' arrangements.*	Both the MONASH model and the University of Adelaide's Centre for Labour Research (on behalf of the Cities of Marion, Mitcham and Onkaparinga) suggest a significant contraction in output and employment should Mitsubishi's manufacturing operations cease. While this modelling is not definitive (as no modelling is) it is a useful indicator of the severity of the loss which may be incurred should of one of the four vehicle producers exit. The South Australian Government continues to support the development of structural adjustment strategies for firms, regions and individuals affected by any significant disruption to the sector. The terms of that assistance should be determined in consultation with State Governments and regional councils.
WORKPLACE ARRANGEMENTS AND INDUSTRIAL RELATIONS ISSUES *Significant progress in improving workplace outcomes is unlikely until firms and employees see it as in their joint interests to work together to further the prospects of their enterprises and the industry.* *Such cooperation would be facilitated by: ensuring that both managers and union leaders are well informed about industrial relations issues and industry requirements; further improving the communication skills of managers in dealing with their workforces and the unions; and ensuring that employees and their unions are properly aware of the relationship between workplace outcomes and the financial viability of firms and the industry more generally.* *Changes to the nature of union coverage in the automotive industry would also be valuable. While not without problems, either an enterprise union system or a single union covering all workers in the industry, could provide much greater coincidence of interests than the current largely occupation-based union structure. In turn, this could help to discourage damaging industrial disputation and facilitate a more cooperative approach to dealing with the many challenges confronting the industry*	 Agreed. Australia's automotive industry has undergone dramatic structural change to achieve high levels of international competitiveness. These changes, such as reliance on just in time inventory management, and development of sophisticated supply chains, have increased the levels of interdependency between firms in the industry. As a result, a competitive automotive industry more than ever before requires a co-operative industrial relations framework. The South Australian Government rejects any suggestion that assistance to the automotive industry be linked to acceptance of a prescribed set of industrial relations reforms. However, the industry requires the benefits of a co-operative industrial relations framework, favouring outcomes that are negotiated rather than protracted and often legalistic disputation. The South Australian Government believes that the present system often encourages resort to costly and generally unproductive court action and other disputation. There needs to be more emphasis on dispute prevention and resolution.

Appropriate regulatory changes to constrain the scope for 'protected' industrial action, and to provide for speedier and more effective resolution of disputes causing significant damage in particular industries or firms, would be beneficial for the automotive industry.	The South Australian Government welcomes the recommendations contained in the paper concerning the need for better training for managers and union representatives within the sector. Such an approach should lead to a better understanding of priorities of the industry and the demands placed on management and union representatives in the agreement negotiation process.
The need to maintain external pressure for better workplace outcomes is one reason for continuing with reductions in government support for the industry.	Workplace reform should not be tied to assistance to the industry. The Government of South Australia welcomes the Commission's view that there should be no direct link made between the parameters of post 2005 assistance and industry performance on workplace relations.
The workers entitlements issue, which has recently caused significant problems in the automotive industry, cannot efficiently be resolved at the enterprise level - industry or even national initiatives are required.	
SKILLING AND TRAINING	
There is no evidence currently of a skills crisis in the Australian automotive industry, although there are emerging shortages in some particular areas.	Measures to identify and address specialised skill sets in emerging fields (eg. virtual engineering, mechatronics, etc) need to be considered. Whilst the required volume of such skills is likely to be comparatively minor, they will be a key determinant in the competitiveness and therefore future of the automotive industry.
The key issue for the future is ensuring that the training system responds effectively and quickly to skilling issues confronting the industry.	Agreed. This must include responsive training at the tertiary (both TAFE and university) level, as well as in-house training conducted by companies. Training and eduction for the sector should reflect advances and prospective advances in technology and manufacturing processes so that the sector is at the forefront of industry practice. An appropriate balance between public investment and industry/enterprise financing of training to meet emerging and higher-skill needs must be determined particularly in the area of company-specific skills. Leadership by industry in identifying future education and training priorities will be critical in addressing future skill needs in the automotive industry.
An external review of training advisory arrangements could be beneficial in helping to ensure that training arrangements and packages continue to meet the needs of the industry.	(Training arrangements/packages are reviewed by the automotive industry every three years or sooner as the need arises). The engagement of local companies in these reviews will be reliant upon national industry advisory arrangements in light of the Commonwealth Government's

	withdrawal of State funding for industry advice from 2002/03.
TAXATION *As a revenue raising instrument, the luxury car tax has deficiencies. If it is retained, the threshold for the tax should be raised so as to adequately reflect price movements in the luxury vehicle market.* *As revenue raising instruments, payroll tax and stamp duty on vehicle sales and transfers also have deficiencies. However, a thorough assessment of the impact on community welfare of these more widely applicable taxes is beyond the scope of this inquiry.* *The 3% revenue duty imposed under the Tariff Concession System disadvantages Australian manufacturers - including automotive firms - and imposes unnecessary costs on their customers.*	
SUPPLY OF INFRASTRUCTURE SERVICES *Microeconomic reform in the transport sector has improved the efficiency and reliability of automotive supply chains. It has also facilitated the emergence of specialist transport suppliers which now play an important role in the just-in-time supply of components to vehicle producers and the distribution of finished vehicles.* *However, continuing inefficiencies in electricity supply arrangements are adversely affecting some automotive producers.* *The current review of energy markets commissioned by the Council of Australian Governments provides a forum to canvass the concerns raised in this inquiry in a broad context, drawing on the experiences of a range of industries.*	South Australia would like to see positive outcomes emerging from the current review of energy markets, an issue of critical concern to the industry.
R&D SUPPORT MEASURES AND WORKERS COMPENSATION *The performance of Australia's general support measures for R&D should be reviewed within five years. Such a review should aim to ensure that there is appropriate general support available for R&D undertaken by Australian industries - including by the automotive industry after the specific support provided through ACIS ceases.* *There would be value in a nationally based review of workers' compensation arrangements.*	This inquiry is the appropriate forum to examine R&D assistance in the automotive industry and in particular its specific characteristics and requirements. This said, a review of Australia's general support measures for R&D would not be unwelcome.
VEHICLE AND RELATED STANDARDS *The delayed introduction in Australia of more stringent emission standards will not, of itself,*	

prevent domestic vehicle producers from upgrading their engine technologies to meet the emission requirements prevailing in global markets.	
In contrast, lower fuel quality standards in Australia could conceivably hinder the uptake of new engine technologies in the domestic industry, as well as resulting in higher emission levels.	Agreed. However consideration must also be given to the adjustment costs to be borne by refineries in order to meet higher fuel quality standards.
The consultative processes of the National Road Transport Commission could provide an avenue for ensuring that significant inconsistencies in standards for new vehicles and vehicles in use do not emerge.	
The introduction of specific standards for aftermarket components that are integral to vehicle safety or to a vehicle's environmental performance could benefit both the community and local suppliers of these components.	This finding has merit.
Proof of safety requirements for new industrial chemicals which have been certified as safe in other developed countries should only apply if circumstances unique to Australia make re-testing necessary.	
FUEL CONSUMPTION TARGETS	
Revisions to current fuel consumption targets should only occur after consultation with the industry to determine what improvements in the fuel efficiency of local vehicles can be achieved without compromising commercial viability.	
Given the shortcomings of average fuel consumption targets as an instrument for reducing fuel consumption, it could be appropriate to examine other ways of pursuing this goal.	Agreed. Alternative policy strategies could be explored a nationally coordinated level with participation of the Federal, State and Territory governments and key stakeholders.
MARKET ACCESS	
Some progress has been made in reducing trade barriers faced by Australia's automotive exporters.	The actual evidence for this in the report is weak, although South Australia accepts that bilateral and multilateral negotiations on trade liberalisation have the potential to improve the entry of Australia's automotive products into international markets. This said, trade liberalisation must be advanced cautiously and with regard to the trade liberalisation agendas of other nations. Unilateral liberalisation on Australia's part will ultimately deliver negligible benefits to the Australian community.
However, significant and widespread trade barriers remain. Moreover, the use of incentives to attract automotive investment appears to be increasing.	South Australia continues to be concerned about tariff and non-tariff barriers to Australia's automotive products. As stated above, it will continue to advocate a considered approach to liberalisation which is linked to market access gains in international markets through multilateral

	and bilateral means.
There are also significant non-government barriers to trade, including the global sourcing strategies of the major automotive producers and the 'understanding' that certain US vehicle producers have with the United Auto Workers to limit importation of vehicles from their overseas subsidiaries.	See above.
WTO and APEC processes are likely to improve Australian automotive exporters' access to overseas markets and should continue to be the focus for Australia's trade negotiation efforts.	South Australia (as outlined above) supports a considered approach to trade liberalisation at the multilateral level, and in particular the establishment of a rules-based trading system which is vital to Australia as an exporting nation.
Some bilateral trade agreements may also be beneficial for the automotive industry but can have adverse impacts on the wider economy and therefore require careful assessment.	The Government of South Australia supports the negotiation of bilateral free trade agreements where these deal with liberalisation in trade of the manufacturing (and specifically automotive) sector. It supports the Commonwealth Government's proposed agreements with Thailand and the United States, as well as with Japan and China.
The case for a successor to Automotive Market Access and Development Strategy is not strong.	

Introduction

The South Australian Government welcomes many of the preliminary findings of the Productivity Commission in its report, *Review of Automotive Assistance: Position Paper*, released in June 2002. The paper examines the assistance regime to apply to the Australian automotive industry in the post-2005 period. Although the South Australian Government has concerns with some of the findings, the general tenor of the findings serve to recognise the many factors that justify continued assistance to the Australian automotive industry. In particular, the position paper acknowledges the significant importance of the industry and the contributions it makes to the economic development (and competitiveness) of the nation as a whole. The many challenges and opportunities facing the industry are also noted to a considerable extent.

Despite its case for decreasing assistance to the automotive sector, the Commission’s overall analysis suggests there are little if any significant welfare gains to be reaped from further reduction in assistance to the industry. In the Commission’s own words:

> The modelling results suggest that the resource allocation gains of reductions in assistance to Australia's automotive industry after 2005 would be very modest. The Commission's in-house MONASH modelling indicated negligible impacts on household income - either small positives or small negatives - depending on the scenario. The Econtech modelling showed similarly inconsequential impacts for the wider economy. Both models also highlighted that any (small) resource allocation gains would be offset by (small) terms of trade impacts. This is in contrast to past modelling exercises where terms of trade effects have been swamped by the resource allocation gains from reducing very high protection.[3]

The bulk of benefits to the community from reducing assistance to the automotive industry have already been achieved as a consequence of previous reductions in protection and, as the Commission’s own economic modelling indicates, there is no real benefit to be achieved from further reductions (indeed, further reductions may yield negative welfare changes for the community). The arguments for further reduction in protection levels are much thinner than in the past.

The industry has largely and successfully negotiated the difficult transition from an inward looking industry (sheltered behind high tariff and quota walls and focussed on a domestic market) to an outward looking industry which is increasingly focussed on exports (notwithstanding ongoing and considerable obstacles to such sales in terms of barriers to trade erected by others). However, the fact remains that the industry operates in a global context where extremely large subsidies and high tariff and non-tariff barriers permeate most of the foreign markets in which Australian producers might seek export growth.

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[3] Productivity Commission, (2002): p110.

To some extent, this reflects the awareness of many foreign governments of the strong degree of spillover effects that are associated with the presence of a domestic automotive industry. Though the Commission notes that spillover effects are not unique to the automotive industry, it does concede that they do exist. As a prime driver of technological change, skills development and management practices change within the Australian economy, it is clear the Australian automotive industry has a very significant position as a generator of positive spillover effects for manufacturing and the economy as a whole and particularly in the regional economies of South Australia and Victoria.

Australia now faces the possibility of risking a significant portion of its automotive industry (and the positive externalities that accrue from its existence) in order to reduce assistance purely on the basis of theory (which can only, *a priori*, be argued as optimal in a distortion free world). In an automotive market that is particularly prone to market distortions across the globe, it cannot be assumed that reduced assistance from an already low level will necessarily provide any gains in allocative efficiency. This perspective is only reinforced by the results of the modelling conducted for this review. It also suggests that the ultimate question that needs to be addressed is not when assistance to the industry should be phased out, but in fact, why should it be phased out at all given the lack of economy-wide benefits that will be derived from such action.

As the Commission notes, continued assistance even at levels of a magnitude similar to that presently in place is no guarantee of a sustained and prosperous domestic automotive industry. It would, however, provide the industry with some counter-balance to the endemic (and much greater) levels of assistance provided in almost every other automotive producing nation without imposing any welfare costs on the Australian economy. Now that the static allocation efficiency gains from reduced automotive industry protection have been exhausted, it essentially becomes a question of terms-of-trade effects versus the dynamic efficiency gains that might be yielded from further reductions in assistance.

The South Australian Government therefore argues that the argument for reduced industry assistance is not as clear as it might at first seem. The Commission appears to recognise this itself in the widespread use of conditional statements and qualifiers in its discussion of what further changes to the assistance regime might imply for the industry. It also notes that the economic modelling showing zero (or negative) national welfare outcomes from further assistance reductions cannot take into consideration the very significant human costs involved in any contraction of the industry.

The succeeding sections of this submission provide further comment on the Commission's position paper by addressing each chapter as presented in that paper.[4]

[4] Attachment 1 contains the summary of recommendations from the South Australian Government from the initial submission to this inquiry (May 2002).

In arriving at its conclusions, South Australia continues to advocate assistance to the automotive sector which:

- promotes investment by making Australia an attractive site for global automotive capital;
- promotes R&D and innovation which lead to product improvement and more efficient and technologically advanced production;
- promotes skills development with the sector workforce, including managerial skills;
- promotes exports of automotive products through greater market access as well as through market development programs; and
- therefore contributes to the industry's self-reliance, viability and growth.

The success of any assistance regime will be evidenced in the sector's continuing contribution to improvements in the national economy as indicated in, among other things, employment, export revenue, investment, technological advance, environmental and safety improvements, and consumer benefits.

The Global Automotive Industry

Within the position paper, the Productivity Commission sketches the salient features of the global automotive industry. It notes that:

- Vehicle production is the largest manufacturing sector in the world, and a key activity in leading industrialised nations (and, increasingly, in industrialising ones as well).

- It has strong and extensive backward linkages to other economic activities (ranging from raw materials to suppliers of sophisticated componentry, as well as tooling and engineering), as well as forward ones — with the implication that if vehicle production contracts there will be deleterious repercussions throughout the economy (if not via first-round then via second and subsequent-round effects).

- The sector is an intense developer and user of advanced product and process technologies and is a mainstay of skills development in numerous activities characteristic of an advanced economy.

Given these features, it is not surprising that the automotive sector has "…led many governments to assist their automotive sectors" and that such interventions have "had a pervasive impact on automotive production and trade."[5] The reasons why the automotive industry in any given country has achieved the status that it currently has is not explored, but would seem in most cases inextricably linked to the provision of assistance for the development of that industry. Although the Commission examines the relatively rapid growth of the industry within many developed countries, it ascribes most of the impetus for these developments to general economic development in these nations. It is suggested here that in many developing countries, the growth in local vehicle demand generated by growing incomes has been of secondary importance when compared with issues such as:

- government investment attraction incentives;

- the availability of suitably skilled people; and

- the locational advantages of many countries.

Moreover, the analysis presented by the Commission suggests that a shift in the balance of automotive production towards developing countries has been occurring. Though this position is supported by the aggregate data, a finer analysis that removes the marked decline in Japan's production share indicates that the rest of the developed world has in fact increased its share of global automotive production. The automotive industry is clearly not simply a phase in a country's transition towards a developed

[5] Productivity Commission (2002): p7.

economy, but one that can be sustained in the most highly developed economies in the world – and is in fact a valuable contributor to a developed economy, as the contribution of the automotive industry to the US, German and Republic of Korea economies attests. Though the automotive industry is without doubt subject to considerable competitive cost pressures which are intensifying, there is nothing particularly new about this development.

The commonly stated need to exploit economies of scale, or more accurately as the Commission states in the position paper, to find "…ways to maximise the global volumes over which production expenditure can be spread,"[6] is not widely examined. The situation in the vehicle industry is less about economies of scale (brand new production facilities incorporating such economies are, for example, a rarity on the Australian scene) than about the continual challenge of operating existing plants more efficiently (and thus achieving minimum achievable unit costs of production). The fact that the emphasis has changed over time from building exactly the same thing in vast numbers to building a number of variants using the same vehicle 'platform' has not changed that imperative radically. In fact, it has elevated flexibility (an Australian strength) as a global competitive advantage.

[6] Productivity Commission (2002): p11.

The Australian automotive industry

The Commission states that the local industry is a microcosm of the global industry. Australia’s automotive industry is now characterised by features such as:

- pervasive change in the industry wherever located (including significant rationalisation);

- improved productivity and product quality in conjunction with the growing importance of innovation and R&D efforts;

- strong growth in both exports and imports, reflecting growing consumer choice within the automotive market;

- a high degree of integration into the global market, with the Australian sector facing similar pressures and constraints as the rest of the automotive world;

- an industry that is concentrated geographically, particularly in the States of Victoria and South Australia (and thus forming the two States likely to face the highest costs of any industry contraction brought about by further assistance reductions);

- a $17 billion turnover representing 6% of national manufacturing,[7] employment of 55,000 Australians and a contribution of some 0.6% to gross domestic product;

- strong and important linkages among segments of the industry (e.g. the high degree of interdependence between vehicle and component manufacturers)[8] and between the industry and the wider economy (both forward linkages to vehicle-related service sector activities such as distribution, retailing, servicing and repair and backward linkages to activities such as iron and steel, paint, rubber, plastics and glass);

- geographical concentration, particularly in South Australia and Victoria (but not limited to these States); and

- important spillovers to the wider economy (with the industry an intensive user of advanced technologies in product and process innovation and also drawing

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7 It is, of course, even more significant an industry in regions where it is geographically concentrated — representing 14% of manufacturing in South Australia and 10% in Victoria.

8 Noting the Commission’s comment that "a major theme in submissions from component producers was that maintenance of a substantial domestic demand base is a pre-requisite for retaining significant component manufacturing activity in Australia." Productivity Commission (2002): p17.

on a varied and increasingly sophisticated skill set including virtual engineering, mechatronics, and advanced design and graphics).

The importance of the automotive industry for the Australian economy and its movement towards the Commonwealth (and South Australian) Government's desire "for an internationally competitive and globally integrated"[9] sector strongly underlines the high stakes involved in ensuring the public policy settings affecting the industry are correct. Erroneous policy (e.g. one that is not in the best interests of the Australian community) will place at substantial risk the future of a vital sector of the economy to no purpose as it continues on the path to international competitiveness.

While the Commission notes that the overall Australian vehicle market has been growing steadily in recent years, with total vehicle sales in 2002 expected to exceed 800,000 units (more than 50% above the levels attained a decade ago), it does not highlight the change in market composition that has been occurring. The large vehicle segment of the market (where local production is concentrated) has been declining - particularly in recent years. This is evident from Figure 3.1 of the Commission's position paper which indicates that 1998 marked a high point for the local industry's production in volume terms with a decline since that time.[10]

A closer examination of the data underlying Figure 1 in the position paper better highlights the declining position of the local producers (something the paper conspicuously fails to do).[11] Here it becomes clear that domestically produced vehicle sales (production less exports) are clearly trending downward over time (at a rate of almost 3%, on average, per annum). Local vehicle producers are progressively losing market share to imports. A further comparison of domestic sales by vehicle producers as a share of the total domestic market (imports plus domestic sales) points to the local producers' share declining, on average, by more than 5.4% per annum.

This is not pointed out to paint a bleak picture for the Australian automotive industry, as the strong export performance of recent times has provided a significant volume increase. Automotive exports have been expanding, on average, by nearly 17% per annum in recent years (dollar value) albeit from a relatively low base (particularly in comparison with the much larger automotive products import total). The boost from exports is not, however, sufficient to prevent local production volumes (domestic sales plus exports) from trending downwards at an average rate of nearly 0.5% per annum over the last decade. The development of niche markets has, on the other hand, served to bolster failing domestic demand.

In all cases, annual averages mask quite large year-to-year movements (reflecting the highly variable nature of the market for automotive products). Clearly, what has actually been happening to the industry over the last decade must cast some doubt on

[9] Productivity Commission (2002): p27.

[10] Productivity Commission (2002): p18.

[11] Productivity Commission (2002): p xx.

unconditional claims of a rosy future for domestic production. However, Appendix B of the position paper appears to claim such a situation. Figure B.1 shows that from a MONASH base-case of 38% cumulative growth to 2016, or about 2.9% a year, none of the post 2005 policy options considered would reduce the output of the passenger motor vehicle (PMV) industry in absolute terms.[12]

The most severe option would trim PMV output growth to a cumulative total of 13%, or about 1.1% a year. The same option is projected to reduce PMV employment by 4.4% a year, rather than the 2.8% a year in the base-case. Either outcome looks somewhat excessive against the yardstick of recent experience. As Figure 1 in the position paper would seem to suggest, history does not necessarily support ‘business as usual’ growth of nearly 3% per annum for the local industry. Moreover, such analysis precedes subsequent discussion of labour adjustment costs and regional employment effects (which are concluded to be not much of a potential problem).

The position paper also makes the claim that, over the last decade, the price of imported vehicles has fallen by an average of 10%, despite the depreciation of the Australian dollar over that timeframe. It also notes that while the average real price of locally produced vehicles is about the same as a decade ago, significant improvements in vehicle quality mean that purchasers are getting better value for money. However, this very lack of lock-step price synchronisation between the price of imported and locally produced vehicles would appear to undermine the only quantitative estimates advanced in the Overview to the position paper.

Evidence from the industry suggests that if tariff assistance were instead delivered through an equivalent production subsidy, the cost to taxpayers would currently be some $360 million a year (and $240 million a year when the tariff falls from 15% to 10% in 2005). Using the Commission's standard methodology for calculating such subsidy equivalents, the costs would be $840 million and $560 million a year, respectively. This support is on top of the subsidies provided to the industry under ACIS which currently represent a cost to revenue of nearly $600 million a year. The key to these significant differences is that the Commission’s methodology assumes that local and imported vehicles are perfect substitutes for each other (and thus, among other things, their prices should move together.)

Interestingly (and more correctly), when it comes to attempting to quantify the likely effects of future assistance options in Appendix B of the position paper, local and imported vehicles are not considered to be perfect substitutes (as the market would seem to suggest). Based on this difference, it is difficult to see why perfect substitution should be assumed when it comes to calculating effective rates of protection and production and consumption subsidies (which serves to raise the costs to consumers) and yet imperfect substitutability be assumed when it comes to attempting to ascertain the impact of future cuts in assistance to the domestic industry (which reduces the apparent negative impact on the industry).

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[12] Productivity Commission (2002): p167.

The position paper notes that local vehicle production is focused in essentially one segment of the market (upper-medium rear-wheel drives) plus some medium-sized car production, but does not elaborate widely on why this situation has developed. Within the domestic market, this is a declining segment. It is also one that is to some extent reliant on fleet sales (where quantity discounts can be expected to put pressure on margins). Consequently, it may not even be a segment which can regularly produce the kinds of margins investors would be looking for to justify the capital involved.

While component production may be more diverse as compared with local vehicle production, its "…sophisticated production capacity in areas like engines, panels, braking and clutch systems, suspension systems, exhausts, transmissions and rear axles, air conditioning, occupant safety, vehicle instrumentation and electronics, lighting and mirrors, and wheels"[13] will count for little if reduced assistance takes its toll on the sector's major customers (i.e. local vehicle producers).

The position paper also states that:

> Ongoing productivity and quality improvement…, favourable movements in the currency and government assistance programs, have all contributed to substantial export growth. Exports now account for more than 30% of automotive production compared to less than 10% a decade ago. The industry has become Australia's sixth largest exporter.[14]

Given this, it may seem somewhat odd to decision makers that, at the very time that an important export industry is emerging in Australia, now is the time to put the entire industry in jeopardy. Surely there would have to be an irresistibly compelling reason to do so. Unfortunately for the Commission's views on appropriate future assistance arrangements for the industry, there is not.

The Commission also outlines the domestic industry's growing international competitiveness and ascribes this to productivity and quality improvements spurred by a number of factors (e.g. rationalisation, growing export orientation, significant investment and innovation and workplace flexibility). However, the report does not examine the ways in which these various trends might also reflect to some extent the inner workings of the industry.

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[13] Productivity Commission (2002): p20.
[14] Productivity Commission (2002): p21.

Outlook for the automotive sector

Within this section of the position paper, the Productivity Commission provides a strengths, weaknesses, opportunities and threats (SWOT) analysis of Australia's automotive industry, as required under the inquiry's terms of reference (under Assessment of Long Term Viability and Opportunities). Although providing a relatively comprehensive examination of the industry, it could be argued that the analysis does not present a full insight into the outlook faced by the domestic automotive industry.

With regard to future opportunities, the Commission makes the wider observation that Australia's total domestic market is small by world standards. The actual market the local industry is contesting is even smaller (and can account for an even smaller share of overseas markets). The Commission is realistic about export prospects, having also admitted that "few firms will be able to rely on domestic sales alone" to enhance (or at least maintain) their viability.[15] For example, the understanding between the United Auto Workers union and certain US vehicle producers to limit vehicle imports is cited as an important non-tariff barrier. It also serves to highlight the complexity and uncertainty involved in substituting foreign demand to compensate for declining domestic market share.

The position paper also notes that Australia is not manufacturing the kinds of cars likely to appeal in already large and growing Asian markets, where access is constrained by both tariff and non-tariff barriers. Moreover, these markets are often seeking to use growing local spending on automotive products to grow a local automotive industry rather than satisfy burgeoning demand via imports.

Whilst noting these issues, the Commission seeks to portray the overall situation in a more balanced tone by noting that:

> the potential importance of niche market exports to Asia should not be underestimated. For instance, sales of just a few thousand units to a number of these markets would collectively provide a significant boost to a producer's total volumes. This is one reason why the industry places such a high priority on improving access to Asian markets.[16]

Noting that component firms may have wider export opportunities available to them, since local components are incorporated in a range of vehicles across the world, the Commission quite properly includes a couple of important caveats even here:

> …demonstrating capability to customers, and developing the linkages with them that are necessary to sustain viable export business, can take a number of

[15] Productivity Commission (2002): pp27-28.
[16] Productivity Commission (2002): p28.

years. Hence, in the short to medium term at least, export opportunities are likely to be concentrated in those markets where:

- Australia is already a well established supplier of components such as in the USA and South Korea; and/or
- links with the Australian vehicle producers allow for truncation of the start-up phase of exporting.

Moreover, securing business with the major global vehicle producers may increasingly require direct investment in production facilities in the markets concerned, rather than the export of finished components from Australia.[17]

The paper also notes that tooling and design firms may generate growing export sales, although it is questionable to what extent this would continue to be the case if reduced assistance precipitated exits from the industry in Australia. The comments relating to the composition of local vehicle production as well as the importance of the ongoing macroeconomic environment and assistance regime serve only to highlight that the industry is genuinely in a situation of both threats and opportunities. They also contrast somewhat with the base-case scenario outlined earlier in the position paper.

The paper does point to various strengths of the Australian automotive industry, including a rapidly improving product and quality record, and growing links between Australian subsidiaries and their overseas parent companies having the potential to aid in the transfer of know-how, production experience and open markets. The potential counter to this is also indicated, which is that potentially competitive Australian automotive production may still encounter closed markets because head office has allocated potential sales to others in the conglomerate. It is the responsibility of local vehicle producers to negotiate larger market shares with their parent companies – at the same time, strongly supportive national policy provides important assistance to local producers when they make their case.

To any list of Australia's automotive industry strengths might be added Australia's comparative advantage in producing low-volume products (in comparison to world-scale plants) that can fill niches that might otherwise be missing from comprehensive product offerings on the part of the large global players in the industry.[18]

The fact that "The limited range of domestic vehicle production leaves the industry vulnerable on several fronts"[19] — the result, as the Commission acknowledges, of past reductions in assistance forcing retreat to that segment of the industry where Australia's comparative advantage in vehicle production is greatest — certainly is a weakness. It is the price paid for the community to reap the gains from cutting formerly high levels of assistance to the automotive industry — with virtually all

[17] Productivity Commission (2002): p29.

[18] The recent announcements of export contracts for the Monaro Coupe and the luxury versions of Mitsubishi's Diamante are indicative of such potential.

[19] Productivity Commission (2002): p32.

prospective gains now reaped[20] and assistance down to what are now quite modest levels.[21] The risk is now that further cuts will see major exits from the Australian industry with the inevitable consequences in terms of knock-on effects, as the Commission acknowledges:

> …reductions in current vehicle production volumes - were, for example, one of the vehicle manufacturers to cease production - would put some significant component production facilities and the associated research infrastructure at risk.[22]

This seems a risk not worth bearing given there is no expected net gain for the community – the Commission admits that Econtech and MONASH domestically focussed modelling shows that "further unilateral reductions in Australia's automotive tariffs would not deliver much of an economy-wide gain."[23]

The Commission also nominates lack of economies of scale in Australia as a weakness. Here it (perhaps inadvertently) confuses genuine economies of scale from the struggle to use already installed capacity to best effect in the face of globally endemic excess capacity. If anything, the importance of economies of scale to automotive production is diminishing over time with the advent of innovations like computer controlled metal working machine tools (which can greatly save on the down-time that was previously involved in switching from making one component to another) and the evolution of the 'platform' in vehicle assembly (whereby multiple models can be built from a common base). What remains overwhelmingly important (because of its implications for unit costs) is to operate plant at its 'design' capacity — itself an elastic concept because assembly lines can be periodically upgraded on the one hand and increasing throughput can justify increasing automation of individual processes on the other.[24] For example:

> In 1997, the daily production rate at Holden's vehicle assembly facility was 480 cars per day. Since that time, Holden has invested around A$43 million in the implementation of a number of initiatives that have now increased the production rate to 620 cars per day… Holden's main body shop [now] runs at automation levels of 80%, while the paint facility runs at 100% automation. When Holden's relatively small volumes are considered with respect to typical

[20] As indicated in the modelling.

[21] Not only is an automotive tariff of 15% modest by historical standards (e.g. in 1985 a 100% tariff applied to 'out of quota' imports — see Figure 9.2 on p91 of the position paper), it is also modest in relation to those applying in other vehicle producing countries (e.g. there is a 25% tariff in the US which assists the popular sports utility vehicle (SUV) segment of its market).

[22] Productivity Commission (2002): p32.

[23] Productivity Commission (2002): p115.

[24] The similarly observed move favouring more commonality in vehicle componentry makes the same point (see Box 4.1 on pg.33).

> world production volumes, the level of automation that has been attained is considered to be in line with world best practices.[25]

That both trade barriers and head offices constrain realisation of economies of scale (or installed capacity, more accurately) via export is without doubt a key issue in the industry. Unfortunately for the industry, these realities do not seem to be prominent considerations when it comes to the Commission outlining what it sees as future assistance options.

Exporters will always favour a weak Australian dollar, particularly if they get paid in a stronger currency. But exchange rates vary over time, and this has been a particular characteristic of the Australian currency. Since exchange rate movements are an equilibrating mechanism, to the extent that the local automotive industry can 'outperform' other exporters, it should not be threatened by Australia’s floating exchange rate. (Development of important industry strengths during previous cuts in assistance has been bolstered by the depreciating Australian dollar). Because of the importance of fleet sales to domestic vehicle producers, it goes without saying that adverse changes here pose a threat.

Under other potential threats, "price suppression in world automotive markets as a result of continuing and substantial excess production capacity"[26] is a strong suggestion that in fact vehicle producers around the world will tend in the direction of marginal cost pricing of exports in order to prevent capacity utilisation falling to levels which have serious consequences for unit costs of production.

Interestingly, one of the threats identified by the Commission— further erosion in the domestic supply base as a result of growth of import share in the domestic market — could be transformed into a reality if the Commission's views on future assistance arrangements prevail. The same applies — but with more immediate and certain consequences — following another listed threat, the exit of a vehicle assembler or major component producers. This may also affect costs to consumers.

Other threats listed range from the industry-specific (uncertainty about future policy settings for the industry) through the fairly industry-specific (the introduction of overly stringent fuel economy targets for either the fleet in general or for government fleets in particular) to 'threats' to Australian industry more generally (changes in global sourcing decisions, or economic downturns, political instability or unrest affecting the industry's major export markets; and failure to undertake further taxation reform and microeconomic reform to improve efficiency in Australia's infrastructure industries).

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[25] Holden Ltd, *Submission to the Productivity Commission Inquiry into Post 2005 Assistance Arrangements for the Automotive Manufacturing Sector* (May 2002): pp28-29.

[26] Productivity Commission (2002): p36.

Arguably the greatest threat to the Australian automotive industry remains the potential for reductions in industry assistance in an environment where there is ample evidence to suggest there is no benefit (and a potential for further loss) for the community as a whole. The Commission notes that the industry is generally optimistic about the future; although it is debatable to what extent this optimism might also be based on assumptions about continuing (but modest) levels of government support for the industry. As Holden notes in its initial submission to the inquiry:

> In a world over-supplied with automobiles, and with a saturated and slow-growing domestic market, Australia's strategic opportunity is to do something different. That something is for each manufacturer to produce a coherent family of niche vehicles to sell on world markets. To succeed in this mission it will be necessary for the vehicles to remain differentiated and relevant over time - which requires continuous innovation.[27]

[27] Holden (2002): p15.

Workplace arrangements and skilling issues

The Productivity Commission highlights a number of concerns with industrial relations in the automotive manufacturing sector. Most notably these relate to the vulnerability of the sector to industrial action at the level of the vehicle manufacturing plants through disruption to the supplier chain and the lack of a "coincidence of interest" within the groups represented in the industry.

Enormous strides have been made in the automotive industry since the days of open-ended assistance (provided by quantitative restrictions on imports and local content rules) which effectively reserved the lion's share of the market for domestic producers irrespective of their competitiveness. The abolition of quotas and local content imperatives plus progressively lowered tariffs have played an important part in the impressive gains made, as have developments in workplace arrangements and industrial relations over the last decade and a half.

However, as the Commission points out, there is still a way to go before the automotive industry can boast the kinds of workplaces other Australian industries can (as evidenced by figures on industrial disputes from the Department of Employment and Workplace Relations). And a perceived poor workplace and industrial relations climate can certainly colour the investment decisions of overseas headquarters in an industry with features which make it particularly vulnerable to any threats to continuity of supply.

It is acknowledged that it is one thing to diagnose the problems in an industry and quite another to propose a solution which all parties will recognise as such and embrace. While the Commission points to issues such as union coverage, multiple unions, pattern bargaining and continuing workplace inflexibilities redolent of the past - and their undesirable consequences - the suggested way to improve the situation going forward is to highlight the need for greater coincidence of interests amongst various stakeholders.

Unconvinced itself that legislative change alone would do the trick of engineering "greater coincidence of interest," the Commission casts around for external pressures that could be brought to bear — arguing, however, that outside initiatives such as making ACIS support conditional on the achievement of particular workplace targets "would be a blunt, administratively difficult and potentially inefficient way of pursuing improved workplace outcomes in the industry."[28]

The Government of South Australia welcomes the Commission's view that there should be no direct link made between the parameters of post 2005 assistance and industry performance on workplace relations. Such a link would be unhelpful in achieving better industrial relations outcomes for the sector. It would also be an inappropriate use of industry assistance to achieve policy outcomes for which it is not

[28] Productivity Commission (2002): p48.

designed. A major negative consequence may be inequitable allocation of ACIS funding to firms.

Skilling

The Commission maintains that there is not a crisis in skills within the automotive industry. While skills levels are certainly not critical, the Government of South Australia does foresee a shortage of specialist skills in the future, particularly in the electronics, tooling and design and products and production engineering fields. Measures to identify and address specialised skill sets in emerging fields (eg. virtual engineering, mechatronics, etc) need to be considered. Whilst the required volume of such skills is likely to be comparatively minor, they will be a key determinant in the competitiveness and therefore future of the automotive industry. Vehicle producers are already competing strongly for a limited pool of domestic engineers and, in some cases, are seeking the necessary skills overseas.

Training and education for the sector should reflect advances and prospective advances in technology and manufacturing processes so that the sector is at the forefront of industry practice. This must include responsive training at the tertiary (both TAFE and university) level, as well as in-house training by companies. An appropriate balance between public investment and industry/enterprise financing of training to meet emerging and higher-skill needs must be determined, particularly in the area of company-specific skills. Leadership by industry in identifying future education and training priorities will be critical in addressing future skill needs in the automotive industry.

Training should focus on the needs of current employees (in terms of upskilling) and also on ensuring that potential employees and new entrants (particularly school leavers and the unemployed) have the skills demanded by firms. Training should also be clearly focussed on assisting the industry to continue to expand its export markets. To this end, TAFE facilities require further funding for upgrading of equipment specific to the automotive industry.

The Government of South Australia welcomes the recommendations contained in the paper concerning the need for better training for managers and union representatives within the sector. Such an approach should lead to a better understanding of priorities of the industry and the demands placed on management and union representatives in the agreement negotiation process. In particular, union representatives will benefit significantly from a greater understanding of the strategic issues impacting on the industry. A key feature of this approach should be access to paid leave arrangements for union delegates undertaking this training.

Taxation and microeconomic reform

The South Australian Government agrees with the importance of taxation and microeconomic reform in determining the future environment in which Australia's automotive industry will operate. It is keen to ensure that policy certainty and transparency is maintained to the extent possible for the industry participants.

The automotive industry, in common with other industries, is subject to a range of taxes (company, revenue tariffs on inputs, GST, FBT and stamp duties) plus a few specifically directed at its products (luxury vehicle tax, registration fees, petrol excise and leasing and depreciation rules where vehicles are claimed as a business expense). The Commission accurately points out that many of these arrangements are less of a concern than in the past (e.g. because the wholesale sales tax was replaced by a GST which does not tax exports), although many submissions provided in the initial phase of the inquiry highlighted ongoing concerns about the possibly deleterious effects of various State and Federal taxes.

In respect of microeconomic reform, South Australia will be aiming to ensure positive outcomes emerging from the current review of energy markets, given the importance attached to matters of energy reform by a large number of industry participants. Further clarification of the flow-through of benefits from reform such as that on the waterfront would also be desirable, given that many participants believed this process had yet to deliver significant reductions in charges for these services.

Safety and environmental issues

As argued in a wide array of submissions and in the position paper itself, community expectations (both in Australia and overseas) are driving improvements in the industry’s safety and environmental performance. The burden that meeting these expectations (and ensuing government regulations) is placing on the domestic industry is acknowledged by the Commission in its comments noting that
“…the setting of broader environmental goals and targets impinging on the industry must have regard to firms' capacity to make the necessary adjustments to their operations.”[29]

In respect of vehicle and related standards, the Commission notes that Australian Design Rules (ADRs) are progressively being aligned (except in unimportant ways) with European ones — so that they will no longer represent a non-tariff barrier to automotive imports. It is also noted that Australia is lagging somewhat behind European emission standards (primarily because the Australian refining industry is yet to undertake the necessary investments to cope with Middle East crude oil imports with their higher sulphur content compared to local feedstock).

On the subject of meeting progressively challenging fuel consumption targets, the Commission sensibly advocates that the pace of such efforts “must have regard to the industry's capacity to deliver” (the targets are to be achieved through negotiation with automotive companies).[30] However, the Commission also notes that:

> … potential environmental and safety benefits reinforce the industry policy arguments for aligning tariffs on passenger and 4WD vehicles. That said, as discussed in chapter 11, industry policy considerations also suggest that such alignment would be best achieved by reducing the passenger vehicle tariff, rather than by raising the tariff on 4WD vehicles.[31]

As outlined in its initial submission, the Government of South Australia recognises that Australian automotive producers must increasingly take into consideration international environmental standards which, in the main, are becoming more stringent. The harmonisation of Australian standards with European ones imparts greater impetus to this process, both in order to meet domestic standards and to compete in international and domestic markets.

The South Australian Government therefore continues to recommend that the Productivity Commission, in considering options for future assistance to the industry, factor in the costs to the automotive industry associated with developing and meeting environmental standards, both domestic and international. Support for R&D to meet (and even exceed) standards should be a feature of any future assistance regime.

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[29] Productivity Commission (2002): p66.
[30] Productivity Commission (2002): p71.
[31] Productivity Commission (2002): p74.

Market access

The Commission’s position paper covers the many issues that arise in relation to market access in respect of the Australian automotive industry. Quite rightly it sees market access as a focal point: “With the industry’s future viability heavily tied to exports, ready access to overseas markets is clearly very important.”[32] As a consequence, the Commission argues – as South Australia argued in its initial submission – that continuing efforts to secure improved market access for Australia’s automotive products is important.[33] South Australia argues that it is indeed critical. While the industry has achieved strong growth in exports, in part this can be attributed to the low Australian dollar. The Commonwealth Government must continue to put great effort into creating a global market structure which can and will support Australian exports even with a rise in the Australian currency.

The Commission notes that exports often involve complicated decision making processes by the parent multinational and incentives for foreign direct investment by national governments – apart from standard tariff and non-tariff barriers - can skew market access and export outcomes. For these reasons, it recognises that:

> A key element in the industry's assistance proposals was that any reductions in Australian vehicle tariffs after 2005 should be tied to progress in reducing trade barriers in other markets.[34]

In spite of the Commission’s contention that “…there has been progress in reducing automotive trade barriers”,[35] little evidence is presented to support this argument. The Commission admits that slow progress in reducing tariffs on the part of ASEAN countries could quickly be reversed at the first sign of significant growth in imports and points to a World Bank study that “provides evidence of some minor liberalisation of import licensing arrangements for automotive products in developing countries,” before noting that “access to virtually all automotive markets is still restricted”.[36]

Emphasising other countries’ automotive tariffs may not even be relevant in the face of even more restrictive non-tariff barriers,[37] noting for example:

> Japan's vehicle distribution system; the EU's controlled franchised and dedicated dealer arrangements; and the `understanding' that certain US vehicle

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32 Productivity Commission (2002): p75.

33 Productivity Commission (2002): p84.

34 Productivity Commission (2002): p75.

35 Productivity Commission (2002): p76.

36 Productivity Commission (2002): p76.

37 FCAI commented that in the case of Korea, “almost impenetrable non-tariff barriers make the tariff rate virtually irrelevant.”

> producers have with the United Auto Workers to limit importation of vehicles from their overseas subsidiaries.[38]

The Commission acknowledges that these often potent combinations of tariff and non-tariff barriers erected against automotive imports by countries keen on supporting their domestic industries (including both developed and developing countries) might serve to "partly explain why import shares in many automotive markets are low" and that these barriers have led to a substantial loss of business for Australian automotive exporters. [39]

Whilst the Commission draws from this a conclusion that offering incentives for automotive firms to set-up within a country might be of questionable utility, the analysis does not provide sufficient information on the resulting costs and benefits to determine whether such incentives have in fact been of little practical benefit. It notes that there are further benefits to be achieved through further multilateral trade negotiations as well as regional and bilateral agreements and new accessions to the World Trade Organisation. The South Australian Government supports continued efforts to achieve genuine trade gains on a multilateral, regional and bilateral basis, but also recognises that gains in this field are often difficult to gain and slow to be realised. In the case of Thailand, for example, there are set to be gains for the automotive sector arising from a proposed bilateral free trade agreement – but only if Australia is careful not to throw away its bargaining chips prior to the commencement of negotiations.

With respect of the Commission's argument that making further reductions in automotive assistance in Australia contingent upon our trading partners doing likewise is making Australia's policy 'hostage' to overseas developments, it is difficult to agree with the logic. Australia has engaged in largely unilateral reductions of its automotive assistance in the past, but there has been no discernible impact on Australian access to overseas automotive markets as a result. While the agenda of trade liberalisation can deliver significant benefits to Australian exporters and consumers, it must be embraced in a considered and cautious manner, taking into consideration (among other things) the trade liberalisation agendas of other nations, particularly in the Asia Pacific region. The Commission's modelling has shown that further unilateral liberalisation will ultimately deliver negligible benefits to the Australian community.

The Commission downplays the usefulness of Australia's automotive assistance regime as a lever in liberalisation negotiations: "Australia's automotive assistance provides little bargaining coin."[40] The bargaining power of Australia through its efforts in the Cairns Group, as well as specific successes in the WTO, suggests the Commission underestimates Australia's muscle in liberalisation negotiations. It also

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38 Productivity Commission (2002): p77.

39 Productivity Commission (2002): pp77-78.

40 Productivity Commission (2002): p83.

underestimates the need for Australia to be able to place real offers on the table in what are, always, reciprocal negotiations. Moreover, Australia is a major beneficiary of the rules-based trading system which derives from multilateral, regional and bilateral negotiations. It must continue to advance the cause of such a system through considered approaches to domestic liberalisation, while leveraging all factors (including standing assistance) in its favour.

The impacts of automotive assistance

It could be argued that progressively reducing assistance to the automotive industry from the days of open-ended protection guaranteed by quantitative restrictions on imports to the modest levels that now prevail has produced a textbook case study of predictable responses:

- industry rationalisation (and significant exits) as remaining activity has become concentrated in areas of comparative advantage;

- increased productivity (and job shedding), along with more keenly priced, higher-quality product offerings; and

- increased imports and, when assistance fell to modest levels, increased exports.

Throughout this process, consumers have effectively reaped the majority of the gains to be made from assistance reductions (as per the findings outlined in Appendix B to the position paper).

In analysing the impacts and the levels of automotive assistance that applied in the past, it is crucial to consider the key role that quotas used to hold in protecting the local industry. Rather than just underpinning automotive protection (even with tariffs of 57.5%), the quotas were essentially the key element of protection for the industry with the tariff acting more or less as a revenue-raising instrument.[41] Thus, when quotas were phased out, an out-of-quota duty rate was initially set at 100% and was progressively lowered so that the tariff would again become the operative protective instrument (with the tariff quota regime eventually being abolished in 1988).[42]

The Commission discusses the variety and magnitude of assistance it believes the automotive industry is able to draw upon, and then proceeds to deliver a figure of some $840 million as the gross subsidy equivalent to the automotive industry. The apparent underlying assumption is that imported vehicles are perfect substitutes for domestic vehicles, which is not consistent with the assumptions used in modelling the likely impacts of reduced assistance as contained in Appendix B of the position paper. In a similar vein, the analysis of 'effective rates of assistance' presented in the paper also makes use of the same assumption of perfect substitutability between domestic and foreign vehicles, which does not seem to make the findings tenable. Perfect substitutability ignores key variables such a consumer demands, costing profiles, and vehicle capabilities, among other things.

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41 Thus the 'tariff equivalent' of quotas probably exceeded 150%.

42 Productivity Commission (2002): Figure 9.2.

Furthermore, the Commission includes in its analysis an estimate of some $1.9 billion as the 'consumer tax equivalent' of existing assistance arrangements. While this figure is derived from a precisely defined concept depending for its calculation on very specific assumptions, the impression is that Australian consumers would be significant beneficiaries without this tax burden. As stated before, the Commission's own analysis in Appendix B indicates that consumers are projected to be worse off (or at best no better off) if automotive assistance were to be further cut.

Finally, with respect to ACIS, it would seem that any fair assessment must await the results of the study being conducted by the industry on the effects of ACIS. As the Commission notes, there can be difficulties in establishing what outcomes would have been produced in the absence of the program - for instance, firms undertook investment, R&D and production before ACIS commenced in 2001.[43] While there must be some uncertainty about how much additional activity is directly attributable to the scheme, its relative newness (with only 18 months of operation) makes a full assessment difficult at this time. Initial evidence from industry participants, however, suggests it has successfully bolstered both investment and R&D. The current study should highlight weaknesses in the scheme which can be addressed in its reformulation from 2005.

[43] Productivity Commission (2002): p104.

Directions for post 2005 assistance

The South Australian Government is in general agreement with the over-riding objective of this inquiry, which is to maximise community welfare in Australia. The Commonwealth Government remains committed to the automotive sector as a valuable contributor to the national economy. At the same time, it has expressed support for an industry which is subject to ‘free and open trade’, assuming Australia’s commitments under APEC and broader WTO obligations are met.

While it is not surprising that the industry and employee associations argue in favour of maintaining the status quo, it does so with good reason and justification. The current performance of the sector is strong: annual turnover exceeds $17 billion, it provides employment for 55,000 Australians, and it accounts for 6% value added and employment in the manufacturing sector. Across the Australian economy, it accounts for 0.6% of value added and employment and is a major contributor to regional economies. Its current profile – although always with room for improvements in efficiency - is consistent with the Commonwealth Government’s stated aims of both a competitive automotive industry and an improved overall economic performance.

Notwithstanding significant concessions made by the Commission throughout the paper – notably, that the policy calculus is now more complex, that potential resource allocation gains have diminished and that the modelling of likely effects suggest that, if anything, there will be a loss in community welfare – the Commission appears to continue firmly in favour of cutting assistance to the industry. It does so on the grounds that ‘dynamic’ considerations have now become more important and that spillover effects remain difficult to quantify. Whilst noting these concerns:

- the dynamic gains – to the extent that they still exist – can be expected to be proportional to (now modest) tariff levels;[44] and

- the assertion that almost all industries generate spillovers does not deal with the relative magnitude of spillovers generated by some industries compared with others (the international nature of the automotive industry would suggest it is a prime candidate for generating significant spillover benefits).

While the judgement that the benefits of past cuts were justified in relation to the costs was a correct call, it is now far from clearly the case — as modelling done for both this and the post 2000 automotive inquiries so amply attest. In other words, with assistance distortions now much reduced, it has become an empirical issue as to

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44 Interestingly, the Commission appears to make the opposite claim (p111): "Unlike the allocative benefits reflected in the models, the ’dynamic’ benefits do not necessarily become proportionately smaller as tariffs are reduced." Logic would suggest, however, that once assistance cuts have forced domestic automotive manufacturers to closely approximate world best practice in terms of all aspects of production — remaining potential 'dynamic' gains would be commensurately smaller.

whether the assumed benefits of further reductions can so confidently be claimed to outweigh the prospective costs. Thus, theoretical arguments (particularly in the presence of distortions) should no longer automatically carry the day when the real issue is now how community welfare is actually likely to be affected by the Commission's proposed changes to automotive industry assistance.

On this issue, one can turn to the modelling work reported in Appendix B for possible guidance:

> Indeed, the quantitative modelling undertaken for this inquiry suggests that these gains could be outweighed by small, but adverse, shifts in the aggregate price of Australia's exports relative to its imports — known as 'terms of trade' effects.[45]

The implication is that it is conceivably in Australia's best interest to have modest tariffs because of the nature of what Australia exports and the induced price effects of boosting export volumes (the so-called optimal tariff theory).

The Commission further notes that:

> With the allocative and terms of trade effects being both small and counter balanced, 'dynamic' considerations that are not encapsulated in quantitative modelling assume much greater importance in formulating future assistance policy. For instance, modelling does not take account of the incentives that assistance reductions can provide for productivity and other improvements (the so-called 'cold shower' effect). Indeed, the failure to make sufficient allowance for such induced changes meant that interpretation of past modelling projections proved to be much too pessimistic, greatly overstating the reductions in output resulting from assistance reductions.[46]

With respect to these comments, the first issue to be noted is that models can (and have been) constructed to capture 'dynamic gains' — the problem seems more a case of the difficulty of quantifying the relationship between what is an inherently 'fuzzy' concept and cuts in assistance, than the challenge of formally incorporating their possibility in modelling work.

The second point is that past modelling projections typically projected fairly modest effects on industry outputs of cutting assistance (essentially because of the assumption of imperfect substitution between imported and domestically produced vehicles).[47] Relatively modest effects were what were also ultimately observed. The situation now, however, is different – cutting all public support invites discontinuous

[45] Productivity Commission (2002): p109.

[46] Productivity Commission (2002): p111.

[47] It was only when the relevant parameters were made to approximate perfect substitution that large output effects were simulated.

responses, such as one or more major exits from the industry. The possibility of discontinuous change is not something modelling of the kind presented within the position paper can handle. To address the possibility of discontinuous change, such change usually has to be imposed on what are continuous models – with consequential caveats on what the models are then supposed to be explaining.

More, continuing and ultimately large cuts in assistance have led to cumulatively large changes - such as imports expanding from around 20% to now accounting for 60% of the passenger motor vehicle market. This is apart from employment contraction within the sector. Given the losses of employment in the industry as protection has been progressively reduced, and the potential for major exits of automotive firms if further cuts in assistance are forthcoming, the Commission may be overly optimistic in its assessment that:

> …modelling undertaken for this inquiry suggests that the transitional costs of the sort of reductions in assistance now in prospect would be relatively modest, particularly in light of the industry's assessment about future growth prospects.[48]

[48] Productivity Commission (2002): p118.

Options for post 2005 assistance

The terms of reference call for the Commission to:

> Analyse the short and long term implications of each policy option, including under present arrangements, for the structure, performance and competitiveness of the sector, employment, regional Australia, consumers, resource allocation and growth prospects generally.

An examination of the Commission’s modelling and its associated analysis located in Appendix B of the position paper raises numerous questions that do not appear to be answered. For example, what does the Commission anticipate the effects of reduced assistance will be on output, employment, investment, prices and imports for the automotive sector (as well on the various parts of the industry, including assemblers, component producers, toolers and other specialist suppliers)?

The South Australian Government also notes that no price effects are reported in Appendix B; while the claim that any (reduced assistance-induced) job losses will be able to be easily accommodated through a slowing in the industry's growth rate is difficult to fathom.

South Australia is keen to ensure that there is no confusion of a buoyant overall automotive market with the rather different state of affairs facing the domestic medium/large segment in which local production is actually concentrated. Similarly, the Commission's view on the relative ease with which it believes possible adjustment pressures may be absorbed by the regions in which the automotive industry is concentrated is not shared by the South Australian Government.

Within the context of the local market, the industry is in decline in terms of its market share - not only is the local vehicle producers' share of the market declining, on average, by 5.4% per annum, but sales are also declining, on average, by 3% per annum; and growing exports are only managing to roughly stabilise production.[49]

With these issues in mind, the following options for the tariff rate to apply post 2005 as well as the future form of ACIS are now revisited.

Automotive Tariffs

The South Australian Government position on tariffs on passenger motor vehicles (PMVs) and some automotive components differs with that of the Commission. While South Australia agrees that the tariff on automotive products should be maintained at 10% from 2005 until 2010, it finds no reasonable case for a further reduction to 5% from 2010 to 2015.

[49] Productivity Commission (2002): Figure 1.

The tariff is an investment attraction device, and a timeframe which sees a 10% tariff in place until at least 2010 delivers an important message to global vehicle and components companies when making investment decisions. The automotive industry faces significant structural and technological change, which cannot be managed without a clear commitment from the Commonwealth Government to the sector within Australia. Australia's relatively modest assistance must continue so as to attract investment, which will assist in enhancing competitiveness in the sector. The symbolic value of a 10% tariff for investment attraction cannot be discounted.

Now is not the time to lock in further reductions beyond the reduction to 10% in 2005. The Productivity Commission has not adequately demonstrated any significant benefits of a proposed 5% tariff over a 10% tariff post 2005. In fact, as the Commission itself finds, such a reduction will provide negligible (even negative) gains to the community. Moreover, a 5% tariff, it can be argued, is equivalent to zero in its effectiveness and will provide the industry with little to no assistance for global integration. Neither the Australian community nor the sector will reap real benefits from any further cuts in the tariff rate below 10%.

Any future decreases in the tariff rate should be dependent upon a detailed assessment of the state of the automotive industry and market conditions, showing as a minimum:

- significant allocative efficiency gains to the Australian economy;
- the meeting of real improvements in global market access outcomes, including reductions in the levels of assistance provided to the automotive industry in other countries;
- a record of continual growth and investment in the South Australian automotive industry; and
- a clear indication that Australia has been positioned long-term as an attractive automotive investment destination by key global car and automotive component manufacturers.

An insistence on further tariff reductions fails to – and indeed cannot – properly take into account the prevailing conditions in 2010 and beyond and in particular the nature of the sector, the national economy and the global environment at that time. Any such decision would be peremptory.

The Commission has acknowledged that the industry receives substantial government support around the globe. At the same time, it contends that there has been reasonable progress in reducing automotive trade barriers. There is little evidence presented to support this argument. While Australia has engaged in largely unilateral reductions of its automotive assistance in the past, there has been no discernible impact on Australian access to overseas automotive markets as a result. The agenda of trade liberalisation can deliver significant benefits to Australian exporters and consumers, but it must be embraced in a considered and cautious manner, taking into consideration (among other things) the trade liberalisation agendas of other nations, particularly in the Asia Pacific region. Further unilateral liberalisation will ultimately deliver negligible benefits to the Australian community.

The South Australian Government therefore does not support any of the Productivity Commission's three pre-determined options on the tariff.

Recommendation 1: The Government of South Australia recommends that automotive tariffs be retained at 10% after 2005, at least until 2010. Any further decision on tariff reductions at this time must be contingent upon a detailed assessment of the automotive industry and market conditions, showing as a minimum:

- significant allocative efficiency gains to the Australian economy;
- the meeting of real improvements in global market access outcomes, including reductions in the levels of assistance provided to the automotive industry in other countries;
- a record of continual growth and investment in the South Australian automotive industry; and
- a clear indication that Australia has been positioned long-term as an attractive automotive investment destination by key global car and automotive component manufacturers.

Any future tariff reductions below 10% should be implemented only after a full (and favourable) assessment of these key conditions has been undertaken in a process, which is fully consultative and transparent.[50]

Automotive Competitiveness and Investment Scheme (ACIS)

The Commission supports the continuation of the Automotive Competitiveness and Investment Scheme (ACIS) beyond 2005 and has put forward three options for the scheme's funding. The Government of South Australia welcomes the view that ACIS (or an equivalent) should continue beyond 2005 at least until 2010. The Government is of the view that current funding levels should be maintained in the five-year period from 2005 to 2010 (Option 1) in order to maintain the impetus for automotive investment in both plant and R&D which is critical to the long-term viability of the industry.

ACIS should continue to promote investment, R&D and production within the industry. Although South Australia sees merit in the Commission's assertion that significant change to the scheme would be unnecessarily disruptive, consideration should be given to more closely aligning the scheme's outcomes with ensuring future growth and innovation within the industry. The scheme should maximise outcomes that promote the industry's international competitiveness. Any changes to the scheme – including on capped and uncapped funding and on separate funding pools – should be determined in close consultation with industry.

The relative newness of the scheme (with only 18 months of operation) makes a full assessment of its success difficult at this time. However, initial evidence from industry participants and strong industry support (from both vehicle manufacturers and component producers) suggests it has successfully bolstered both investment and R&D. It has assisted the industry in taking up (and developing) new technologies and in building new plant, i.e. it has supported the growing competence of the sector. South Australia therefore supports the industry view of the efficacy of the program and its contribution to structural adjustment within the sector which will contribute to its long-term viability.[51]

This process of adjustment is, however, not yet complete, and some elements of the sector are still on the road to international competitiveness. Withdrawal of the scheme in 2005 could have the effect of suddenly halting the structural changes now underway.

South Australia does not agree with the Commission's view that ACIS is purely a mechanism to support the industry during transition. In combination with the tariff, it is an important device to attract international investment into the sector and, as such, its lifespan and level of funding should be determined with investment attraction firmly in mind. Indeed, the argument for the scheme to continue is made stronger with the fall of the tariff to 10% in 2005. The tariff and ACIS are an integrated package for ensuring the long-term viability of the industry – important symbolically for investment decisions as well as in terms of real benefits. Any decision on the future of ACIS should be made in conjunction with policy decisions on the tariff.

Recommendation 2: The Government of South Australia recommends the continuation of ACIS (or its equivalent) at least until 2010. Any proposed changes to ACIS must reflect the need to promote factors that contribute to the automotive sector's growth and competitiveness in Australia, such as investment, research and development, innovation and increased production. Continuation of ACIS after 2010 should be assessed by the Commonwealth Government in consultation with industry, State and Territory Governments, and other key stakeholders.

Recommendation 3: Of the three options presented by the Commission on the funding of ACIS, the Government of South Australia has a preference for Option 1 – but any decision on the funding and timing of the scheme should be made in conjunction with decisions on the tariff.

Market Access

South Australia welcomes the Commission's acknowledgment that market access is a key issue for the sector (although the gains made to date have been less optimistic than the position paper would suggest) and its recognition that the Australian industry faces significant tariff and non-tariff barriers to export with its trading partners and with potential partners.

There is no evidence that Australia's commitment to leading the way in the APEC trade liberalisation agenda has improved market access for Australian automotive products. The 'demonstration effect' has no basis in reality.

The Government of South Australia continues to be disappointed with the market access outcomes achieved for Australian automotive products, particularly within the Asian region. Following the 1997 Commission review, industry support for the reduction in automotive tariff was contingent upon the Commonwealth increasing its efforts to achieve gains in market access. However, there is little evidence that the promised market access gains have been achieved. Making headway on market access issues must be a critical factor in the determination of future policy on assistance to the industry, and in particular on tariff levels.

Recommendation 4: The Government of South Australia encourages the Commonwealth Government to redouble its efforts in achieving improved market access outcomes for automotive products through multilateral, regional and bilateral trade negotiations. It continues to be of the firm view that further reductions in automotive assistance should not take place in the absence of such progress.

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[50] This position is consistent with the Government's initial position put to the Commission. See Government of South Australia, *South Australian Government Submission to the Productivity Commission on Post 2005 Arrangements for the Automotive Manufacturing Sector*, (May 2002): p4-5.

[51] See Federation of Automotive Products Manufacturers, (May 2002).

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Broader adjustment issues

The Productivity Commission notes that the automotive industry will need to constantly adjust to broad and ongoing pressures (including policy-induced ones):

> …some changes required in the Australian industry to secure its longer term viability could potentially have significant adjustment implications for individual firms and their employees and particular regions. For example:
>
> - Efforts to realise greater economies of scale will almost certainly require further rationalisation in the industry, much of which still operates at output volumes that are low by international standards;
> - Lean manufacturing requirements and associated developments such as modularisation will require major component suppliers to locate closer to the vehicle producers;
> - And, the development of an industry able to compete without significant government support will require further substantial changes in workplace practices, culture and attitudes; and
> - The implication is that irrespective of what assistance arrangements are put in place after 2005, the possibility of potentially disruptive adjustment at the firm and regional level cannot be ruled out.[52]

Whilst the uncertainty inherent in any enterprise, particularly one located in an industry as complex as the automotive industry, makes these comments true, it should not be construed to indicate that assistance arrangements post 2005 could not be instrumental (particularly in a marginal case) in leading to disruptions. As the terms of reference for the inquiry allude to, there is an inter-dependence between vehicle assemblers and component producers and an inextricable nexus between the sustainability of one segment of the industry if the number of firms in the other decrease.

Ultimately, this issue boils down to a question of just how much adjustment capacity exists within firms and at the regional level. The Commission appears somewhat sanguine about the ability of the automotive industry to make any necessary adjustments at the firm and regional level, contending successively that:

- past adjustment experiences are encouraging;
- there have been significant improvements in the skills of the workforce; and
- regional dependence on the industry has diminished.

[52] Productivity Commission (2002): p138.

At the same time, it concedes that other factors will limit firm and regional adjustment capacity. The Commission outlines in broad form the characteristics that should mark any adjustment programs (that may or may not be warranted by the closure of a significant automotive plant), in order that they:

- facilitate rather than hinder necessary change;
- target individuals for whom adjustment pressures are most acute and who are unlikely to be able to cope without additional assistance;
- be of limited duration so as encourage transition;
- be simple to administer; and
- be compatible with general 'safety net' arrangements.

While South Australia appreciates the acknowledgment of concern at possible firm and regional adjustment costs contained within the position paper, it is concerned that the Commission consistently underestimates the adjustment costs should the industry contract. Adjustment within South Australia and Victoria has the potential to be extremely costly. For South Australia in particular, where the automotive industry is a proportionally larger contributor to the State economy, the issue of adjustment is of major importance.

Input-output modelling undertaken by the Centre for Labour Research examines the impact of three scenarios on the southern suburbs in Adelaide – a 25%, a 75% and a 100% reduction in the scale of Mitsubishi's operations. In the best case, i.e. a 25% reduction, the Centre forecasts the direct loss of 850 FTE positions and the indirect loss of 4,800 throughout the economy. This scenario also suggests a loss of approximately $840 million in direct value added to the state economy (2001).[53] This said, the South Australian Government is pleased to note the Commission's view that it "sees a need to ensure that strategies are in place to address any significant firm or regional adjustment problems that might arise in the future."[54]

South Australia has already experienced significant economic adjustment and associated social stresses resulting from general reductions in industry assistance. While total employment in the State has grown in net terms, some groups, such as mature aged males displaced from the automotive (and other manufacturing) sectors, have remained in the ranks of the long-term jobless or have withdrawn from the labour market altogether. This has resulted in significant costs to individuals, families,

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53 Centre for Labour Research, Submission to the Productivity Commission Inquiry into the Post 2005 Assistance arrangements for the automotive manufacturing sector: A Joint Submission by Cities of Marion, Mitcham and Onkaparinga, (April 2002): p3.

54 Pg 134, position paper

the community and economy. These costs have not been properly capture or analysed by the Commission.

In terms of labour adjustment, one argument for assistance is to expand export markets so that any currently underutilised labour is put back to work with the demand for labour not only maintained but, in the best case scenario, expanded. Efforts for market access therefore take on a greater urgency.

It should be noted that while the Commonwealth Government has in the past implemented adjustment strategies, there has also been a significant budgetary burden on State and Territory Governments resulting from structural unemployment and associated social and economic costs. Due to the nature of the automotive industry in particular (traditionally comprised of lower skilled and/or mature aged males) and its regional concentration in Adelaide's northern and southern suburbs, adjustment problems will potentially be significant and long term. As the Commission is aware, the northern and southern suburbs already record high levels of unemployment and so the absorption of new unemployed workers is likely to be minimal.

In the case of the automotive industry, the adjustment burden will disproportionately fall upon South Australia and Victoria. The Commonwealth Government therefore needs to be explicit in its commitment to any structural adjustment programs required.

The Commission's view on the relative ease with which it believes possible adjustment pressures may be absorbed by the regions in which the automotive industry is concentrated is therefore not shared by the South Australian Government.

Recommendation 5: The South Australian Government is dissatisfied with the Commission's assessment of the costs of regional adjustment in the automotive industry and believes that a more detailed analysis should be provided in its final report. In particular, the Commission should take into greater account regional studies presented to the current inquiry.

Economic Modelling Issues

In an address by the Chairman to industry representatives delivered on 26 March 2002, Gary Banks had this to say on the role of modelling in the inquiry:

> While modelling can provide useful insights about how the impacts of policy changes in one area can flow through to other firms and industries, it is easy to lose sight of the limitations of modelling approaches. In particular, the results generated by economic models can be highly sensitive to the assumptions and abstractions that must be made to reduce the complexity of a modern economy to manageable analytical dimensions. Data limitations are a further constraint. Moreover, where individual parties rely on different models:
>
> - there can be debate on the technical intricacies of those 'competing' models; and
> - even if the assumptions and workings of each model are transparent, if different scenarios are being analysed, it can be difficult to ascertain commonalities and underlying differences in projected outcomes.
>
> It would be fair to say that economic modelling in the last inquiry was sometimes used in such as way as to *confuse* rather than clarify the tradeoffs in different policy choices. That did not help the Government and it did not do justice to the considerable efforts of the people involved. We therefore want to avoid any repetition of that in the present inquiry.[55]

Notwithstanding the limitations of quantitative analysis, an understandable requirement on the part of decision makers to be informed of the likely consequences of changed assistance arrangements for the industry means that there is a demand to know what such 'modelling' efforts have to say in terms of likely effects. Hence the need to include such material in the position paper and the Commission admission that "[e]conomic models can play a useful role in illustrating the size and the direction of impacts of policy changes."[56]

[55] Address to the Southern Region of the Federation of Automotive Products Manufacturers, on the public inquiry into post 2005 assistance arrangements for the automotive manufacturing sector, Melbourne, 26 March 2002.

[56] Productivity Commission (2002): p110.

Analysis of what might actually happen if public policy towards the automotive industry were to change is contained in Appendix B of the position paper, which models the effects of post 2005 assistance reductions using the various scenarios presented. Findings from the modelling contained in the position paper can be summarised as follows:

- The resource allocation gains of reductions in assistance to Australia's automotive industry after 2005 would be very modest.
- The Commission's in-house MONASH modelling indicates negligible impacts on household income – either small positives or small negatives – depending on the scenario.
- The Econtech modelling showed similarly inconsequential impacts for the wider economy.
- Both models also highlight that any (small) resource allocation gains would be offset by (small) terms of trade impacts.

As already outlined, modelling has demonstrated little value in further assistance reduction – in fact, the impact may be negative. Both the Econtech and in-house MONASH models indicate that resource allocation gains would most likely be offset by terms of trade impacts.[57] In light of the results from the economic modelling, it does not seem prudent to push ahead for significant reductions in assistance particularly where the justification for such moves would be based on the quantitative negligible welfare gains that might be achieved for the Australian community as a whole (as indicated in position paper Table B.1).

Recommendations for further analysis

Whilst recognising the complex issues involved in attempting to model something as complicated as a modern economy, there are several further issues that can be raised with the modelling. Primarily, there appears to be a lack of information provided on the values adopted for the simulations. Given that the Commission adopts infinite import substitution elasticities in parts of its report (such as where it calculates effective rates of assistance and consumer tax equivalents), it would be useful to see an equivalent of Table B.1 (as contained in the position paper) with import substitution elasticities mirroring the values for the export demand elasticities in terms of the estimated effects on the automotive industry.

It would also be useful if further modelling could be performed with respect to recalculating Table B.6 (indicating the effects on industry employment of rapidly eliminating PMV and general tariffs) using import substitution elasticities of 4, 10 and 20. The current table appears to be predicated on export demand elasticities of 10 but there is no obvious indication of what values have been assigned to the import

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57 Productivity Commission, *Review of Automotive Assistance: Position Paper*, (June 2002): p110.

substitution elasticities for the automotive industry. Additionally, since the MONASH model presented does not disaggregate the automotive sector into vehicle and component production, it would also be useful if the MM600+ model results could be included in an extended Table B.6 in the Commission's final report.

One of the scenarios modelled in the position paper was that of a plant closure; it would be useful in gaining further insight were the Commission to include results on this for both the MM600+ model as well as the MONASH model in its final report. Moreover, an extension of the analysis which would be of significant value would be to simulate more than one major plant closure, which would assist in placing the possible impacts of plant closure in perspective.

Attachment 1

Recommendations from May 2002 Submission

The South Australian Government continues to recommend that the Commonwealth Government maintain current levels of assistance to the automotive manufacturing industry for at least five years from 2005, when tariffs on passenger motor vehicles (PMVs) and components fall to 10%.

To this end, the South Australian Government makes the following specific recommendations as per its original submission to the Productivity Commission on this matter in May:

Recommendation 1

The South Australian Government does not oppose the reduction of PMV and components tariffs in 2005 from the current level of 15% to 10%. Beyond 2005, however, South Australia recommends the retention of these tariffs at 10% at least until 2010 and until real market access outcomes are achieved that result in increased access to markets throughout the world and particularly in Asia.

Maintenance of a 10% PMV and components tariff beyond 2005 is supported by the following arguments:

- Automotive tariffs should not be reduced until real market access gains have been made for Australian exporters – reciprocity should be sought before any decision is made to further reduce Australian tariffs.
- The existence of a tariff helps to attract foreign investment from global automotive companies – even at low levels it is an important signal to the industry that the sector has national support.
- Tariff reductions should be made incrementally to allow the automotive industry time to adjust.
- For reductions below 10%, any welfare gains through improvements in allocative efficiency will be trivial (as indicated by the modelling contained in the position paper) and will be outweighed by adjustment costs and negative changes in the terms-of-trade.

South Australia maintains its recommendation that the retention of tariffs on light commercial vehicles (LCVs) and four wheel drives (4WDs) and components for these vehicles be kept at the current level of 5% after 2005 and at least until 2010.

Recommendation 2

The South Australian Government recommends that the Commonwealth Government continue for at least five years from 2005 an assistance scheme which promotes investment, R&D and production within the industry, such as has been provided under the Automotive Competitiveness and Investment Scheme (ACIS), and which is WTO-compliant and retains overall funding levels as under the current scheme [will need to specify actual funding based on PC options and comments from stakeholders].

The current ACIS scheme promotes production, capital investment and R&D activity – all vital if the automotive manufacturing industry is to be viable and globally competitive. It sends an important international signal that Australia is committed to having a strong, local automotive manufacturing sector and, if extended, will contribute to a stable policy environment suited to the long lead times inherent in the industry. Moreover, the scheme promotes international competitiveness while remaining WTO-compliant. Any modified scheme should retain these principles.

Recommendation 3

The South Australian Government recommends that improved market access continue to be pursued, both in the multilateral and bilateral spheres. The South Australian Government is of the firm view that further reductions in Australian automotive industry assistance should not be contemplated until significant market access gains have been achieved in major automotive markets throughout the world and particularly in Asia.

Continued growth in the Australian automotive industry will be heavily reliant on the Commonwealth Government being able to leverage market access outcomes in overseas markets. South Australia is concerned about the lack of market access gains realised through multilateral trade groupings since the 1997 inquiry. This is of particular importance to Australia where a relatively small domestic market means that companies are increasingly looking for export sales to remain viable by exploiting economies of scale.

Recommendation 4

The South Australian Government recommends that the Commonwealth Government have in place strategies to deal with structural adjustment issues should the automotive industry suffer a significant and sudden contraction in output and employment. Further, any such strategies should be designed to provide a focus on those individual regions in which the industry is concentrated.

Structural assistance programs should aim to:

- assist workers made redundant by structural change within the industry, including through labour, training and re-training programs; and
- assist regions negatively impacted by industry adjustment to find new economically sustainable industries to maintain overall levels of employment and economic wellbeing.

South Australia, as a regional economy and as proportionately most dependent on the automotive industry compared with all other states and territories, expects to have input into the development of such programs. The South Australian Government places a high priority on regional adjustment given the dependence of Adelaide's northern and southern suburbs on automotive production activity.

Programs should be specific and well-targeted. Key issues that should be investigated by the Productivity Commission are the effects on employment, investment, output and income levels in regions where the automotive industry is highly concentrated.

Recommendation 5

The South Australian Government recognises that the Commonwealth Government has a pivotal role in investment attraction for the automotive industry. It therefore, in encouraging the Commonwealth Government to bolster national investment policy:

> *(5.1) urges the Commonwealth Government to make implementation of the recommendations of the Blackburne Report,* Winning investment: Strategy, people and partnerships, *a priority; and*
> *(5.2) affirms the key role the Strategic Investment Coordination program (SIC) plays in actively attracting and supporting mobile global capital – and recognises that on large investment projects there is a need for federal and state/territory cooperation.*

Competition for new foreign investment in the automotive industry is strong, with Australian firms having to compete against a host of sister plants in numerous locations throughout the world and with governments who are prepared to go to great lengths to attract foreign investment. The long lead times required, specifically for the introduction of new car models, dictate the need for a degree of certainty in economic policy in order to allow firms to plan future investment in the domestic industry. A proactive and well-resourced national investment policy is vital if Australia is to succeed in an industry as globally driven as automotive manufacturing.

Recommendation 6

The South Australian Government supports the Commonwealth Government's continued commitment to dedicated and general assistance to the industry as it is currently delivered through Commonwealth agencies and programs.

The automotive manufacturing sector receives Commonwealth Government assistance through dedicated resources within Commonwealth agencies, including Invest Australia, the Department of Industry, Tourism and Resources, Austrade and the Department of Foreign Affairs and Trade. Australia's overseas missions play an important role in identifying markets for Australian products. In addition, the industry receives assistance through non-industry specific programs including through R&D Start, the Export Market Development Grants scheme (EMDG), and R&D tax concessions. These resources form an important part of a national structure which is supportive of both the automotive industry and the economy more generally and should remain open to the sector.

South Australia recognises the need for this assistance to be performance-based and subject to regular review to ensure that objectives related to efficiency and the effectiveness of assistances are being achieved.

Recommendation 7

The South Australian Government recommends, in formulating its options for consideration by the Commonwealth Government, that:

> *(7.1) the Productivity Commission take into consideration the additional expenditure, research and development that will be required by domestic vehicle assemblers and component suppliers to develop and comply with environmental regulations due to be implemented in Australia by 2006; and*
> *(7.2) such options not delay the implementation of these environmental regulations but be consistent with the achievement of their aims.*

Australian automotive producers must increasingly take into consideration international environmental standards which, in the main, are becoming more stringent. The harmonisation of Australian standards with European ones imparts greater impetus to this process, both in order to meet domestic standards and to compete in international and domestic markets.

The South Australian Government recommends that the Productivity Commission, in considering options for future assistance to the industry, factor in the costs to the automotive industry associated with developing and meeting environmental standards, both domestic and international. Support for R&D to meet (and even exceed) standards should be a feature of any future assistance regime.

These recommendations of the South Australian Government collectively address the needs of industry development and growth in that they:

- promote investment by making Australia an attractive site for global automotive capital;
- promote R&D and innovation which lead to product improvement and more efficient and technologically advanced production;
- promote skills development with the sector workforce, including managerial skills;
- promote exports of automotive products through greater market access as well as through market development programs; and
- therefore contribute to the industry's self-reliance, viability and growth.

Importantly, the measures recommended aim to encourage greater industry self-reliance in the longer term while providing vital assistance as restructuring continues in the shorter term.

The success of any such arrangements should be evident in the continuing contribution of the industry to improvement in the economic performance of the Australian economy. A key measurement will be the generation of employment, particularly in regional areas, including those in South Australia. As an important by-product, the Australian consumer will have better access to good quality, fairly priced vehicles. Provision of such vehicles produced by local manufacturers will provide added impetus to the domestic economy – and to the community generally through positive environmental spin-offs through improved fuel and emissions standards.

It remains the view of the South Australian Government that the recommended measures *will* meet the Commonwealth Government's desire for an efficient, internationally competitive industry which can increasingly contribute to the economic wellbeing of the nation. It is also remains the Government's view that the implementation of such recommendations will contribute to both the retention and the future growth of a vibrant and important automotive industry within South Australia and Australia more widely.