



**INDUSTRY COMMISSION**  
**SUBMISSION TO THE**  
**SHIPBUILDING INDUSTRY**  
**REVIEW**

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**INDUSTRY**  
**COMMISSION**

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## FOREWORD

In January 1998, the Commonwealth Government established the Shipbuilding Industry Review Panel to examine the Australian shipbuilding industry. This review is occurring at the tail end of an extended phase-out of bounty assistance for Australia's lightweight shipbuilding industry. Indeed, the bounty no longer applies to orders for which commitments were entered into after the end of 1997.

The Panel is considering, among other matters, the long-term strategic direction of the industry both with and without a bounty. Its deliberations are occurring against the backdrop of the OECD Shipbuilding Agreement. Once implemented, this Agreement will prohibit most forms of government support to shipbuilders.

In preparing this submission, the Commission has not undertaken a detailed investigation of the shipbuilding industry. Rather, it has sought to promote consideration of the economy-wide impact of the policies under review.

The submission focuses on two issues confronting the Panel. It discusses some of the key considerations relevant to an assessment of whether resurrecting bounty support for the industry might be warranted and whether Australia should accede to the OECD Shipbuilding Agreement.

Gary Banks  
Acting Chairperson



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## OVERVIEW

The review of shipbuilding in Australia follows a period of major transformation in the industry. Vessels built in Australia today have little in common with those built in the traditional steel-based shipyards of yesteryear. The firms are different, the materials and technology are different, and the workforce and infrastructure are new.

These changes have been particularly evident in the lightweight end of the market. Australia has established itself as a world leader in the production of fast, lightweight, aluminium-hulled ferries, catamarans, yachts and similar vessels. Australia's reputation has been built upon innovative design and technology, high productivity and successful marketing. Testimony to the industry's success is that more than 90 per cent of lightweight vessels completed in 1996–97, worth around \$300 million, were destined for export markets. More than 2000 people were directly employed in the production of these vessels.

Much of this success is attributable to the industry's efforts.

But support from the Commonwealth Government has also played a role. In particular, there has been longstanding bounty support for the production of domestic lightweight vessels. While the level of bounty support has been phasing down over the last decade or so, the extension of the bounty to exports in the mid-1980s undoubtedly served to encourage more outward-looking attitudes in the industry.

Although the bounty has now been terminated for new vessels, it will continue to apply until mid-1999 for vessels which were under construction or subject to firm commitment at the end of 1997. For these vessels, the rate of bounty support is 5 per cent of construction cost. Annual bounty payments in recent years have been a little over \$20 million and, for individual recipients, have averaged more than \$1.5 million a year. The industry also has access to more generally available export support, such as the services of the Export Finance and Insurance Corporation (EFIC).

### **The OECD Shipbuilding Agreement**

Future support for the domestic industry will depend, in part, on progress in implementing the OECD Shipbuilding Agreement. When (or if) the Agreement

comes into force, it will require member countries to end subsidies to their shipbuilding industries.

While Australia has not yet decided whether to accede to the Agreement, accession would seem consistent with a range of multilateral and regional trade agreements to which Australia is a party. And it would also seem consistent with the broad thrust of arguments Australia is mounting in various international fora to remove remaining impediments to trade. Thus, if the Panel were to find that Australia should not sign the Agreement, it would need to clearly demonstrate why shipbuilding should be treated differently from other parts of the economy, or that there are defects with this particular Agreement.

However, there have been continuing delays in implementing the Agreement. Given the prospect of further delays, the terms of reference for this review raise the question of whether the decision to terminate bounty support for the industry should be reassessed. This submission is intended primarily to address that issue. In so doing, the Commission has not attempted to replicate the Panel's task and provide a definitive answer on whether there is a robust case for continuing the bounty in the longer term. Rather, it has focused on some of the key issues relevant to such an assessment. As such, the submission constitutes a form of 'checklist' for the Panel.

## **Assessing the case for continued support**

Government support for particular industries is only warranted if it benefits the nation as a whole. Like any assistance scheme, the benefits of the bounty to the Australian shipbuilding industry will have come at a cost to activity elsewhere in the economy. In particular, assistance for shipbuilding will have attracted resources away from other activities and thereby reduced their competitiveness. This is not to deny the possibility that the benefits of the bounty may have outweighed these costs. However, it points to the importance of the Panel adopting an economy-wide perspective when assessing the case for resurrecting bounty support, rather than simply looking at the benefits for the shipbuilding industry.

### *Compensating for assistance elsewhere*

One possible argument for resurrecting bounty assistance would be to provide shipbuilding with a level of support similar to that available to other Australian industries. The underlying rationale would be to prevent resources flowing to less efficient, assisted activities.

However, even at the current low level of 5 per cent, the bounty and related arrangements provide more generous support than that available to most other manufacturing industries. In particular, tariff protection for other industries provides assistance only for domestic sales, whereas the shipbuilding bounty also assists exports. In addition, the industry has benefited from special arrangements giving it wider access to duty-free imported materials and parts than most other industries. In 1996–97, the industry received about double the level of support (in effective rate terms) provided to manufacturing as a whole.

Thus, the bounty rate required to offset the impacts of assistance provided to other activities would be much lower than 5 per cent, and would fall further as assistance elsewhere in the economy continues to decline. Whether it would be sensible to reintroduce the bounty at such a very low rate is debatable, particularly given the accompanying compliance costs for the industry, administrative costs for government and the efficiency costs of raising revenue to pay for the bounty.

A related argument is that a bounty is justified to compensate for subsidies available to competitors overseas. If foreign subsidies were a short-term aberration, then this argument might have some merit. That is, the provision of support domestically could help to prevent the ‘double adjustment’ costs that would otherwise arise when resources moved out of and then back into the industry.

But, in fact, corrupt prices and subsidies in the shipbuilding industry are longstanding and may well continue for some time yet. In these circumstances, it is unlikely to make economic sense for Australia to try to match overseas support. A better policy will generally be to seek to have such assistance removed through multilateral arrangements (such as the OECD Shipbuilding Agreement) and, in the interim, use our resources to the best possible advantage in the constrained environment.

In any event, Australia has already terminated bounty assistance for new vessels. Hence, decisions on the future scale of activity in the industry may already have been taken on the basis of no bounty support. This raises the question of whether reintroduction of the bounty may be too late to avoid any double adjustment costs.

### *Market failures*

Another possible justification for resurrecting bounty support would be if there were significant ‘failures’ in the shipbuilding market. This is most likely to be the case if there are beneficial spillovers (‘externalities’) from shipbuilding to other activities.



However, it is easy to overstate the policy significance of externalities, or to confuse them with normal features of the marketplace. For example:

- Like most export activities, exporting by Australian shipbuilders may help to develop overseas markets and provide market intelligence to other firms. But to justify assistance, these spillovers would have to be substantial, accompany all of the sector's export activity and be of benefit to other industries. A similar test should apply to the argument that the industry provides technological benefits for other activities. Moreover, there are already general government programs in place to address spillovers accompanying export market development and research and development activity.
- The practice of counting increased activity in related industries as a benefit of government support is usually inappropriate. As already noted, whatever the overall effects on community welfare, increased activity encouraged by government assistance is usually matched by reduced activity elsewhere in the economy. Thus, assistance has (less visible) negative as well as positive 'multiplier' effects which must be taken into account.

### *Regional development*

Improving efficiency is not the only reason that governments intervene in markets. One common reason given for industry assistance is to promote regional development.

Bountiable shipbuilding activity is concentrated in Perth and Hobart. In 1996–97, only 2 to 3 per cent of bounty payments assisted shipbuilding outside the capital cities. And, even in Hobart, the amounts involved (bounty payments of around \$9 million in 1996–97) must be viewed in the context of a regional economy of some \$4 billion.

More importantly, a generally available bounty is an indirect and therefore costly way of helping particular regions. This is because it is paid to *all* qualifying shipbuilders, irrespective of location. Accordingly, there are likely to be more cost-effective means of pursuing any regional objectives.

### *A checklist*

The considerations outlined above provide the basis for a checklist to assist the Panel in its deliberations (see box overleaf).

### Checklist for assessing support to the shipbuilding industry

- Does shipbuilding have genuine externalities, as distinct from multiplier effects?
- If so, do these apply to all shipbuilding activity? (Otherwise an across-the-board bounty would be inappropriate.)
- Do these spillovers extend beyond shipbuilding? (Otherwise they could be addressed by, say, an industry levy on shipbuilders used to encourage the activity that provides the spillovers.)
- Are these spillovers significant enough to warrant remedial action, bearing in mind the costs that inevitably accompany intervention?
- Are they already addressed by more general industry programs?
- A bounty set to provide shipbuilders with an equivalent level of support to other manufacturing industries would entail a low percentage rate of payment. Could this be justified given compliance and administrative costs?
- Given that the bounty has already ceased for new orders, is there evidence that providing assistance to the local industry as compensation for overseas support would avoid double adjustment costs?
- Are there more cost-effective ways than a generally available bounty of meeting any regional development objectives?

### Adjustment assistance

The terms of reference ask the Panel to consider whether adjustment assistance for the industry is warranted in the event of implementation of the OECD Shipbuilding Agreement and Australia's accession to it.

There will be circumstances where adjustment assistance is warranted on either efficiency or equity grounds. For example, governments usually reduce support to highly-assisted activities gradually and may sometimes also provide retraining programs for displaced employees.

However, a number of factors would militate against the provision of adjustment assistance specific to the shipbuilding industry:

- The industry has had a long period of notice about Australia's possible accession to the Shipbuilding Agreement. Moreover, the Agreement offers the prospect of higher prices for the industry's exports.

- There has already been a long and generous phase-down in the bounty. Moreover, as noted earlier, for new orders the industry is already operating without bounty support.
- The industry has access to general industry support mechanisms, including EFIC export credit arrangements. Similarly, any retrenched workers would have access to general retraining programs and support.

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# 1 INTRODUCTION

## 1.1 What is the review about?

Australia has a long history in shipbuilding. While small by world standards, the Australian industry is a significant exporter and is viewed as among the world's best in some lightweight niche markets.

Government support for shipbuilding has also been longstanding. Assistance to lightweight shipbuilding has been provided in the form of a bounty (or production subsidy) which has been phasing down over the past decade. The bounty, currently 5 per cent, is scheduled to terminate in 1999. It has, in effect, already ceased for new orders (see chapter 2).

In January 1998, the Minister for Industry, Science and Tourism appointed a Panel to review the Australian shipbuilding industry. The Panel is considering:

- the long-term strategic direction of the industry, with and without the bounty which has applied to vessels of 150 to 20 000 gross construction tonnes;
- the impact of the bounty on lightweight shipbuilding in Australia, in the context of other countries' subsidies;
- OECD and other competing countries' assistance arrangements; and
- options for transitional arrangements in the event of the OECD Shipbuilding Agreement — which aims to prohibit a wide range of shipbuilding subsidies — taking effect and Australia becoming a signatory.

The review is to be completed by the end of June 1998.

## 1.2 Why is the Commission making a submission?

The Industry Commission has extensive experience in examining industry policy issues in an economy-wide context and in analysing arguments put forward to justify industry support. It has undertaken many inquiries into specific industries and into government policies affecting industry as a whole. Included amongst these have been several inquiries into the bounty assistance provided to manufacturing industries, including shipbuilding. The Commission also undertakes extensive general industry research. And increasingly, it is making submissions to reviews of industry policy undertaken by other groups.

The Commission's main purpose in making submissions to other reviews is to provide information and promote the consideration of the economy-wide effects of the policies concerned. This is particularly pertinent to this review, given the lack of explicit recognition in the Panel's terms of reference of the need for such an economy-wide perspective.

Also notable in this review is that the highly export-oriented lightweight shipbuilding industry receives government assistance not available to most other exporting activities. In addition, the terms of reference raise policy issues of broader significance — in particular, whether provision of assistance by overseas governments is a reason for matching assistance in Australia.

### **1.3 Approach taken in this submission**

In preparing this submission, the Commission has not sought to address the full range of issues confronting the Panel. Accordingly it has not undertaken a detailed examination of the shipbuilding industry. This is the Panel's task.

Rather, drawing on its experience across a range of industries, the Commission has sought to focus on some key policy questions germane to any review of industry support and discuss a range of related issues which the Panel will need to address. As such, the submission constitutes a 'checklist' to assist the Panel.

More specifically, the Commission has looked at:

- considerations relevant to assessing whether Australia should accede to the OECD Shipbuilding Agreement (chapter 3); and
- circumstances in which continuing support for the lightweight shipbuilding industry might be justified, as well as the pros and cons of providing transitional assistance in the event of Australia's accession to the Shipbuilding Agreement (chapter 4).

As a prelude to this discussion, chapter 2 provides some background information on the Australian shipbuilding industry, the assistance it receives from government and developments internationally.

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## **2 INDUSTRY AND ASSISTANCE PROFILE**

### **2.1 The international shipbuilding industry**

For many years, the international industry has been characterised by prolonged periods of excess capacity and widespread government support to shipbuilding firms. Growing concerns about the adverse impacts of this support have led to the development of the OECD Shipbuilding Agreement (see chapter 3).

Within this market environment, Japan, with around 75 major shipyards, has been the world leader in shipbuilding since the second world war. In 1994, major shipbuilding nations, ranked by vessel completions (measured in gross registered tonnage (GRT) — the internal capacity of a ship), were:

- Japan, 8.6 million GRT;
- South Korea, 4.1 million GRT;
- Germany, 1.0 million GRT; and
- China, 0.7 million GRT.

Together, these four countries accounted for around three-quarters of total world production.

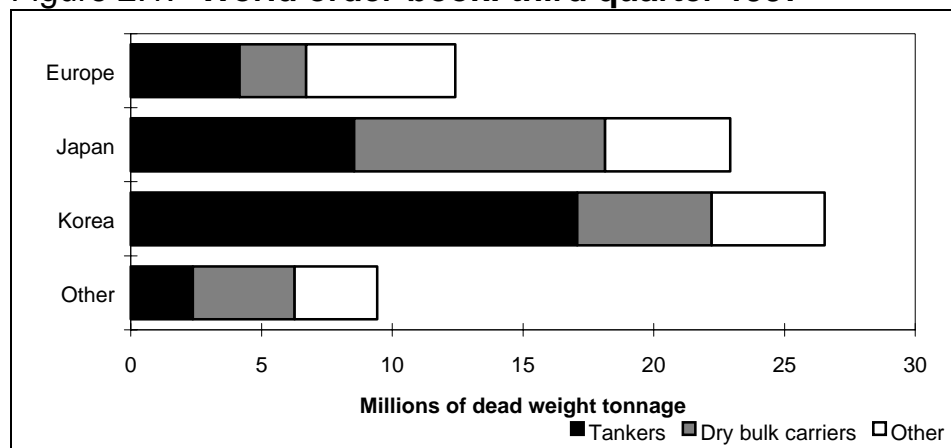
Since 1994, South Korea has challenged Japan's number one ranking. Indeed, in terms of world orders for 1997 — the heaviest order-book for more than a decade — South Korea nudged Japan from top position (figure 2.1). The Defence Industry Committee (DIC 1995) suggested that China could also become a leading player at some stage in the future.

The growth in the Japanese and South Korean industries has coincided with a decline in European shipbuilding. Its share of world ship production fell from 36 per cent in 1975 to 14 per cent in 1984, with further, but lesser, declines in subsequent years (DIC 1995).

### **2.2 The Australian shipbuilding industry**

In aggregate terms, Australia is a minor player in the world shipbuilding industry. In 1994, Australian shipyards produced around 15 000 GRT or 0.08 per cent of world GRT (DIC 1995).

Figure 2.1: World order-book: third quarter 1997



Source: Lloyd's Shipping Economist, December 1997.

However, these aggregate figures conceal the fact that Australia is a significant producer in some, lightweight, niche markets — especially fast ferries, motor yachts and catamarans. In this regard, DIC (1995, p. 176) noted that:

The principal market for the [domestic] commercial shipbuilding sector is the world market for high-speed lightweight ferries and for high-speed lightweight motor yachts. It is estimated that the Australian industry currently supplies about 30 per cent of the total market of about \$1000 million.

Thus, while Australia produced less than 0.1 per cent of world GRT in 1994, it built more than 2 per cent of the number of ships completed around the world in that year.

Australia's significance in these niche markets is an outcome of striking structural change in the local industry since the 1980s. Vessels built in Australia today have little in common with the output from the traditional steel-based shipyards that characterised the industry until the 1980s. The BIE (1995, p. 15) reported:

The types of ships being built are very different; the materials and technology are different; the firms are different; the locations are different; the workforce and infrastructure are new. It is probably more correct to say that a new industry has replaced the old, than to say that the old industry has been transformed.

Today, the Australian shipbuilding industry comprises:

- bountiable production of vessels between 150 and 20 000 gross construction tons (GCT);
- defence-related production for the Commonwealth — for example, naval vessels — which is not eligible for bounty assistance;

- construction of non-bountiable civilian vessels (that is, vessels up to 150 GCT and/or vessels exported to New Zealand); and
- repair services to the water transport industry.

In 1995–96, turnover in the industry was over \$1.6 billion (ABS 1997). Much of this activity was defence-related. (The Commission (1994) estimated the defence share at around two-thirds, although this can vary markedly with ‘lumpy’ defence expenditures.) The significance of the defence component reflects not only the volume of work and the size of vessels, but also expensive fit-outs — the armaments and electronics embodied in defence shipping mean that a commercial vessel of equivalent size to a naval frigate can be constructed for as little as one-tenth of the cost.

Around 7000 people are employed in shipbuilding and repair establishments around Australia (ABS 1997). A BIE (1995) snapshot of shipbuilding employment in 1981 and 1992 — spanning a period of significant structural change — revealed that the share of Australia-wide shipbuilding employment for New South Wales had fallen from 61 per cent to 38 per cent. Conversely, employment shares increased in Tasmania (from 0.7 per cent to 7.0 per cent) and in Western Australia (from 2.5 per cent to 13 per cent). Both of these States have significant bountiable activity.

Australia’s strength in the production of smaller vessels shows up in official trade data for 1996–97. These reveal a high export-to-import ratio for:

- cruise ships and ferries;
- warships (such as patrol boats); and
- yachts and other pleasure craft.

The BIE (1995) made similar observations and noted that, for larger vessels such as tankers, imports overwhelmed exports.

### **Bountiable production**

As noted above, there have been considerable changes in the bountiable segment of the Australian shipbuilding industry. Up until the mid-1980s, the bounty (and registration procedures) had been directed at restructuring traditional shipyards producing fishing boats, tugs and barges (IAC 1988). Yet, by 1994, around two-thirds of the 22 shipyards that were registered in 1988 had closed or lost their registration, and a new lightweight, high-speed vessel industry had emerged. Today, the bountiable ships sector is, by any benchmark, an innovative and dynamic industry winning niche business on design and performance. DIC (1995, p. 64) reported that:



It is generally accepted that Australia's lightweight shipbuilding industry is a leader in the market. This is not simply a matter of productivity — it is the quality of the product, the extent of innovation in design, the success of the marketing and the attractiveness of the finance package, as well as the costs linked to the productivity of both labour and capital. The industry has a good reputation for assessing what the market wants, for being able to respond promptly to inquiries, and for being able to put together a proposal that is attractive to the prospective purchaser. Australia's product quality is good, and the productivity of the yards is high. The price of production is competitive with that of both the high labour cost and the low labour cost competitors.

A snapshot of the bountiable sector, based on a survey of registered shipbuilders (DIST 1997), is provided in table 2.1. It indicates a relatively small but highly export-oriented industry sector. Around three-quarters of completed vessels in 1996–97 were exported, with more than 90 per cent of vessels under construction or on firm order destined for overseas markets. In value terms, the export shares were even higher.

**Table 2.1: The bountiable shipbuilding industry: 1996–97**

	<i>Number</i>	<i>\$ million<sup>a</sup></i>
Registered shipbuilders	11	na
Employment	2 778	na
Investment	na	19.5
R&D expenditure	na	25
Bounty payments	na	22.5
Vessels completed	27	316
Vessels under construction	32	372
Vessels on firm order	13	144
Exports		
- Completed	20	299
- Under construction	28	356
- On firm order	13	144

a Values refer to construction costs. Order-book and employment data refer to the end of the financial year.

na Not applicable.

Source: DIST (1997).

Other salient points to emerge from the survey include:

- 27 vessels were completed in 1996–97 compared with 30 in 1995–96 and the peak of 38 in 1993–94;
- the value of vessels completed (in construction cost terms) rose by around 32 per cent from the 1995–96 figure of \$240 million;
- the unit value of completed vessels rose from \$8 million to \$12 million;
- the value of the order-book increased by 4.5 per cent;
- employment fell by 17 per cent in the year to June 1997 — although in the previous four years it had grown strongly (see table 2.3);
- R&D expenditure increased from \$2 million in 1995–96 to \$25 million. However, one shipbuilder reported R&D expenditure of nearly \$24 million for an ‘experimental’ vessel;
- investment increased by around 70 per cent to \$20 million; and
- average capacity utilisation was around 80 per cent.

### *Composition of production*

In 1996–97, 16 of the 27 completed bountiable vessels were ferries. The share of ferries and yachts in bountiable production has grown from around 30 per cent in the mid-1980s to around two-thirds today.

In world terms, Australia now accounts for a significant share of the production of these types of vessels. Data from *Fairplay* (October 1994) reported in BIE (1995), while incomplete, indicate that Australian shipyards held around 7 per cent of world orders (10 out of 137) for new passenger ferries. Moreover, all passenger ferries under construction in Australia at that time were 4000 GRT or less. At this lighter end of the ferry market, Australia’s order book of 10 vessels represented over 12 per cent of global orders, and 16 per cent of GRT (table 2.2). In addition, Australian shipyards supplied about 40 per cent of world GRT in the catamaran market.

### *Export markets*

As discussed above, a very high proportion of bountiable vessel production is exported. In stark contrast, from 1981 to 1984, the entire output of the bountiable sector was sold in Australia.

**Table 2.2: New buildings of passenger ferries less than 4000 tonnes GRT: October 1994**

	<i>No.</i>	<i>Total GRT</i>	<i>Per cent of GRT</i>
Australia	10	16 600	16
Spain	3	12 000	11
Germany	6	11 600	11
Finland	3	9 300	9
United States	5	8 500	8
United Kingdom	10	8 000	8
Italy	7	7 700	7
Egypt	7	6 300	6
Japan	3	4 900	5
Turkey	2	4 800	5
Singapore	7	3 400	3
Other <sup>a</sup>	19	12 800	10
<b>TOTAL</b>	<b>82</b>	<b>105 900</b>	<b>100</b>

a Indonesia, Norway, Denmark, India, Netherlands, Chile, South Korea and France.

Source: BIE (1995) based on *Fairplay*, October 1994.

During the industry's initial forays into overseas markets in the 1980s, a significant share of exports was to Africa, North America and Pacific countries.

In the 1990s, however, Asia has become the most significant export market — especially fast ferries to China, Hong Kong and Singapore. The United Kingdom has also been a significant market for large wave-piercing catamarans. Looking ahead, the DIST survey revealed that, in terms of 'enquiries' at the end of June 1996, 30 per cent were from South East Asia, 20 per cent from Europe, 17 per cent from Australia and 13 per cent from the Pacific Islands.

While the Australian industry is now established as a significant supplier of high-speed, lightweight, vessels, it is likely to face increasing competition in the future. DIC (1995) made several observations in this regard:

- Hong Kong and China, which have been substantial markets for Australian ferries, may be expected to focus increasingly on technology acquisition for their emerging industries. Similarly, Japanese shipbuilders may try to gain access to the current technology (p. 25); and

- competitors will make significant advances in productivity via better production control and higher levels of automation — Australian shipbuilding may also need to go down this path (p. 65).

### *Employment*

Employment (including subcontractors) by registered shipbuilders totalled 2778 at June 1997 — about 40 per cent of the total jobs in domestic shipbuilding and repair.

As noted above, total employment by registered shipbuilders at June 1997 was some 17 per cent lower than a year earlier. However, direct employment on bountiable vessels fell by only 23 to 2205 (DIST 1997). Moreover, total employment in the sector in 1997 was still considerably higher than in the early 1990s (see table 2.3).

**Table 2.3: Employment by registered shipbuilders<sup>a</sup>: 1993 to 1997**

<i>At 30 June</i>	<i>Employment (inc. subcontractors)</i>	<i>Direct employment</i>
1993	2064	1608
1994	2306	1860
1995	2950	2177
1996	3334	2766
1997	2778	2349

a Registered under the *Bounty (Ships) Act 1989*.

Source: DIST (1997).

## **2.3 Assistance arrangements**

Commercial shipbuilding around the world has a long history of government support, including: construction grants and subsidies; restructuring, financing and scrap-and-build aids; export assistance; tax concessions; customs duties, levies and restrictions; and R&D assistance. The industry is also replete with anecdotal evidence of non-transparent support mechanisms. For example, Japanese shipyards have claimed that Korean state-owned shipping companies have placed orders domestically without opening bidding to overseas yards, and that Korean steel firms have supplied domestic shipyards with subsidised steel plate (BIE 1995).

Against this backdrop, the OECD Shipbuilding Agreement (refer chapter 3) can be considered a milestone. The Agreement will outlaw direct and indirect subsidies in shipbuilding. It will also provide an industry-specific anti-dumping

mechanism, establish a dispute resolution mechanism and provide for negotiated phase-out arrangements for existing assistance regimes. Once ratified, the Agreement will cover about 80 per cent of the world shipbuilding market. Most of Australia's competitors in the ferry market are signatories to the Agreement (BIE 1995).

### **Domestic assistance arrangements**

Assistance to Australia's lightweight shipbuilding industry is provided through a mix of instruments. Small imported vessels less than 150 GCT attract a 5 per cent tariff. Imported vessels above this weight enter duty free. As already noted, however, a bounty applies to domestic production of vessels in the 150 to 20 000 GCT range. Moreover, a policy by-law gives producers of vessels above 150 GCT access to duty free imports of most parts and materials.

Bounty arrangements for Australia's shipbuilding industries have demonstrated remarkable longevity, effectively having been in place since the 1940s (box 2.1). They have outlasted bounties applying to a range of other activities, for example, textile, clothing and footwear products, computers, books, paper, high alloy steel, ethanol and machine tools and robots.

That said, government policy on the bounty has fluctuated in recent years.

In November 1988, following a Commission inquiry into *Ships, Boats and Other Vessels* (IAC 1988), the Minister for Industry, Technology and Commerce announced a new bounty scheme to operate from July 1989. The bounty rate was initially set at 15 per cent, phasing down to 5 per cent from July 1993 to June 1995. It was the Government's intention that the bounty would terminate after June 1995. At the time, the Minister noted that the success of the bounty 'will allow us to cease direct subsidies to this industry altogether by 1995' (Button 1988).

However, in 1993, the *Bounty (Ships) Amendment Act 1993* increased the rate of bounty from 5 to 9 per cent, and introduced a new phasing agreement which extended the bounty to 1996–97. The rationale for this change was to extend bounty assistance to accord with phased reductions in general manufacturing tariffs and to meet the Government's election commitment of February 1993.

#### **Box 2.1: Bounty assistance to shipbuilding: a history**

- 1940: shipbuilding bounty introduced.

- 1943: bounty withdrawn as no claims for payment made.
- 1947: bounty re-introduced to equate vessel building costs with those in the United Kingdom.
- 1975: cost-based scheme (from 1947) replaced by a bounty on selling price.
- 1980: *Bounty (Ships) Act 1980* provides for a bounty, as a percentage of construction cost, for vessels over 150 tonnes and fishing vessels over 21 metres, as well as for the costs of modifications to vessels where costs exceed \$400 000. Bounty payable only for vessels intended for use in Australian waters.
- 1984: Bounty extended to cover eligible vessels built for export.
- 1988: Two rates of bounty payment set — 20 per cent of construction costs for prescribed vessels (eg tugs, bulk carriers and fishing vessels) and modification work, and 15 per cent for construction of other eligible vessels.
- 1989: *Bounty (Ships) Act 1989* introduced. Payments on eligible construction costs for self-propelled navigable vessels greater than 150 tonnes and less than 20 000 tonnes regardless of end-use. Bounty applying to ship repairs terminates. Bounty rate set at 15 per cent from July 1988, phasing down to 5 per cent for the period July 1993 to June 1995.
- 1993: *Bounty (Ships) Amendment Act 1993* extends bounty in line with manufacturing tariffs — 9 per cent for 1993–94, 7 per cent for 1995–96 and 5 per cent for 1996–97.
- 1996: Bounty for shipbuilding terminated on 20 August, as did bounties for machine tools and robots, ethanol and books. The computer bounty terminated in July 1997.
- 1996 (December): Government re-introduces shipbuilding bounty (at 5 per cent) to December 1997 to align assistance for the industry with key overseas competitors.
- 1997: Government extends bounty to 1999 for commitments entered into by 31 December 1997. To be eligible, vessels must be at least 50 per cent complete by 30 June 1999 (pro rata payments apply for vessels 50 to 100 per cent complete).
- 1998: Shipbuilding Industry Review Panel announced.

Sources: Commonwealth of Australia (1992); DIST (1994); IC Annual Report (various).

The future of the bounty arrangements beyond 1996–97 was subsequently considered in the *Review of the Shipbuilding Bounty* (BIE 1995) released in February 1995. The BIE's view was somewhat contingent on developments with respect to the OECD Shipbuilding Agreement. It noted that:

Australia should seek to join the OECD Agreement unless there are strong reasons to expect that it will be ineffective. In the event that Australia joins the Agreement, the bounty would not be renewed when the current legislation expires in June 1997.

In August 1996, the shipbuilding bounty, along with a number of other bounties, was terminated as part of Commonwealth Budget initiatives. The Government announced that, while no new applications would be received, claims would be paid on work-in-progress for vessels completed by June 1997.

Four months later, the Government re-introduced the bounty until the end of December 1997, noting its intention to monitor the OECD Shipbuilding Agreement. At the time, the Government foreshadowed that it would review the need for any further extension of the bounty during the second half of 1997.

In 1997, the Government further extended the bounty (at the 5 per cent rate) to 1999 for commitments entered into by 31 December 1997. To be eligible for bounty, vessels must be at least 50 per cent complete by 30 June 1999 — pro rata payments apply to vessels 50 to 100 per cent complete. For commitments entered into from the beginning of 1998, no bounty will be payable. However, the Panel has indicated that, as part of this review, it will consider whether a further period of bounty support is warranted.

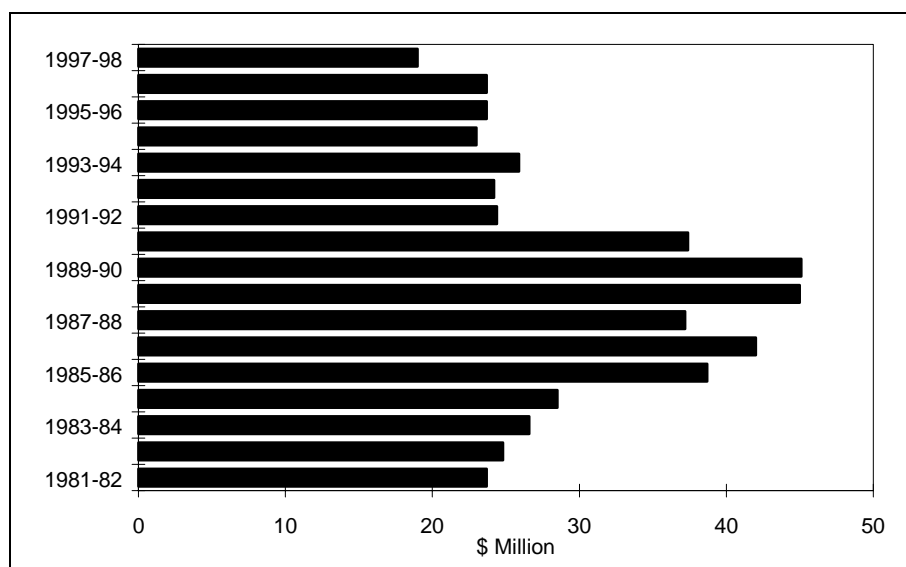
Much of the recent to-ing and fro-ing on the bounty has ostensibly reflected delays in the ratification of the OECD Shipbuilding Agreement. It had been envisaged that the Agreement would be in force by July 1996. However, because of problems with ratification of the Agreement by the United States Congress, this did not eventuate (see chapter 3).

### *Bounty payments and effective assistance*

Total bounty payments peaked in the late 1980s at around \$45 million a year. Rapid growth at that time reflected the extension of the bounty to export production. With the decline in bounty rates, payments have since stabilised at a little over \$20 million a year (figure 2.2).

The bulk of bounty payments have gone to shipbuilders in Western Australia and one producer in Tasmania (table 2.4). In 1996–97, the average bounty payment to each of the 14 recipients was about \$1.6 million.

Figure 2.2: **Total shipbuilding bounty payments: 1981–82 to 1997–98**



a Figure for 1997–98 is a budget estimate.

Source: ACS, Bounty Acts — Return for Parliament (various issues).

Table 2.4: **Bounty payments and number of recipients<sup>a</sup> by State: 1991–92 to 1996–97 (\$m)**

	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>NSW</i>	<i>Tas</i>	<i>Total</i>	<i>Average<sup>b</sup></i>
1991–92	3.0 (3)	12.3 (6)	2.8 (2)	0.2 (1)	6.0 (2)	24.4	1.7
1992–93	2.0 (3)	13.6 (5)	1.5 (2)	0.4 (2)	6.8 (1)	24.2	1.9
1993–94	1.2 (3)	18.2 (9)	0.4 (1)	..	6.1 (1)	25.9	1.9
1994–95	2.8 (3)	12.8 (11)	0.5 (2)	..	6.8 (1)	23.0	1.4
1995–96	1.2 (2)	11.1 (7)	2.0 (2)	..	9.4 (1)	23.7	2.0
1996–97	0.5 (2)	12.4 (9)	0.7 (1)	0.2 (1)	8.8 (1)	22.5	1.6

a Number of recipients in brackets.

b Total bounty payments divided by number of Australia-wide recipients.

Source: ACS, Bounty Acts — Return for Parliament (various issues).

In nominal rate terms, assistance afforded bountiable shipbuilding is not greatly different from the manufacturing sector as a whole (table 2.5). This reflects the fact that the bounty rate of 5 per cent is not greatly different to many residual tariffs (and is significantly less than the tariffs applying in the passenger motor vehicle and textile, clothing and footwear sectors).



However, unlike tariff support, the shipbuilding bounty supports exports as well as vessels for domestic use. Thus, in light of the industry's export orientation, it is considerably more generous than a tariff of the same rate.

Moreover, shipbuilders also benefit from a policy by-law which provides for duty-free entry of most imported parts and materials. Of course, being highly export oriented, the industry could otherwise avail itself of more general provisions that exempt exporters from duty on their imported inputs. Nevertheless, the by-law clearly is of benefit to the industry's production for the domestic market. The effective rate of assistance for shipbuilding is more than double the manufacturing average (table 2.5).

**Table 2.5: Assistance afforded manufacturing and bountiable shipbuilding: 1996–97 and 2000–01<sup>a</sup>**

<i>Sector</i>	<i>Nominal rate 1996–97</i>	<i>Nominal rate 2000–01</i>	<i>Effective rate 1996–97</i>	<i>Effective rate 2000–01</i>
Total manufacturing	4	3	6	5
Bountiable shipbuilding <sup>b</sup>	5	.. <sup>c</sup>	12	.. <sup>c</sup>

a Does not include assistance from access to EFIC and EMDG support.

b Assumes a materials to output ratio of 0.55 (BIE 1995) and a nominal rate on materials of zero.

c Not estimated. However, if the bounty were reactivated and ran through to 2000–01, the nominal and effective rates of assistance for shipbuilding would be similar to 1996–97.

*Source:* Commission estimates.

### *Other forms of assistance*

Given the bountiable sector's export orientation, it benefits from general export programs such as the services provided by the Export Finance and Insurance Corporation (EFIC) and, to a much lesser extent, the Export Market Development Grants (EMDG) scheme.

The BIE (1995) considered EFIC services to be one of the main non-bounty forms of assistance available to the industry. EFIC provides loans to buyers of up to 80 per cent of the contract value of eligible ships — EFIC pays the shipbuilder and the buyer repays EFIC on extended terms. These arrangements are consistent with the OECD Arrangement on Export Credits which specifies export finance conditions for new sea-going vessels. Nonetheless, EFIC considers that its terms are the most favourable permitted under that Arrangement (see EFIC brochures).

EMDG grants are payable in respect of a range of marketing activities relating to overseas sales. The taxable grants cover 50 per cent of eligible expenditures

(after the first \$15 000). Grants are limited to \$200 000 for individuals and \$500 000 for approved trading houses. However, they are not available to firms with export revenues over \$25 million or which have received eight previous grants.

The Commission was not able to ascertain the level of EMDG payments made to bountiable shipbuilders, although it notes that these could potentially be significant for some firms. For example, as noted above, the average unit value of a bountiable ship in 1996–97 was around \$12 million (in construction cost terms). Thus, a maximum grant of \$500 000 on one ‘average bountiable vessel’ would represent about 4 per cent of its cost — close to the level of bounty support. But equally, the eligibility criteria may rule out payments to many firms in the industry.

The Commission considers it important that the Panel report on the extent of assistance to shipbuilders from general programs such as EFIC and EMDG.



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## 3 THE OECD SHIPBUILDING AGREEMENT

### 3.1 An outline of the Shipbuilding Agreement

The OECD ‘Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry’ (Shipbuilding Agreement) seeks to establish a ‘level playing field’ for competition in the shipbuilding industries of OECD countries. To this end, the Agreement aims to establish binding subsidy- and dumping-free conditions in commercial shipbuilding. Should the Agreement come into force, it will extend to 80 per cent of the world shipbuilding industry. Significant shipbuilders outside the (initial) boundaries of the Agreement are Brazil, China, Poland, Russia and Ukraine.

The Agreement contains three major elements:

- prohibitions on measures of support to commercial shipbuilding;
- extension of anti-dumping provisions to shipbuilding; and
- binding dispute settlement and enforcement mechanisms.

#### **Government support measures**

The Agreement heavily constrains the scope for government support to the shipbuilding industry by prohibiting (and instituting the elimination of existing) export subsidies, grants, soft loans, forgiveness of debt, provision of subsidised goods and services (including assistance to downstream suppliers), tax concessions and regulations that favour domestic shipbuilding.

Permitted support measures are limited to restructuring support, assistance to workers, certain research and development (R&D) assistance and non-concessional credits to foreign and domestic buyers of ships (for example, EFIC support).

#### **‘Injurious pricing’**

The Agreement makes provision for a shipbuilding-specific anti-dumping mechanism. This is in response to concerns about the difficulty of applying general anti-dumping measures to shipbuilding activity (see section 3.3).

The determination of injurious pricing and injury will closely follow the GATT Anti-Dumping Code. However, differences arise with respect to sanctions. Where dumping is established under the Shipbuilding Agreement, an ‘injurious

pricing charge' will be levied on the vessel in question and paid by the *exporting shipbuilder* (or the shipbuilder may void the sale or comply with some other remedy). In contrast, under general anti-dumping arrangements sanctions are imposed on the importer.

### **Remedies and sanctions**

In cases where violations of the government support provisions are confirmed by an independent international panel, the illegal support measure must be terminated and benefits paid back (with interest) by the shipbuilder that received the support.

If a government fails to end the support measure or the shipbuilder does not return the illegal benefit, sanctions can be authorised. These include:

- suspension by the adversely affected party (or parties) of undertakings to reduce or eliminate similar prohibited measures on the shipbuilding product(s) in question; and
- denial to the illegally subsidised shipbuilder of the right to complain about dumping by other shipbuilders.

In relation to proven cases of dumping, where a shipbuilder refuses to pay an 'injurious pricing charge' or void the sale of the vessel, the complainant country may deny on- and off-loading privileges to vessels built by that shipbuilder.

### **3.2 State of play**

In December 1994, the Commission of the European Communities, and the Governments of Finland, Japan, South Korea, Norway and the United States signed the Final Act of the Agreement. The Agreement will enter into force once all of the parties have concluded their national ratification procedures.

While it was envisaged that the Agreement would come into effect in July 1996, the United States is yet to ratify it. All other parties completed ratification procedures in 1995 (OECD 1996, 1997a, 1997b).

At an OECD Workshop on Shipbuilding Policies in December 1997, the Chairman of the OECD Council Working Party on Shipbuilding urged the United States Congress to move quickly to a vote on the Agreement. Lloyd's Shipping Economist (1998) reports resistance to the Agreement by members of the United States Congress and the American Shipbuilders Association — consisting of the six largest shipyards in the United States. Apparently, their concerns include special exemptions granted to some signatories and the fact

that some emerging shipbuilding nations are not party to the Agreement. The Director of the Shipbuilders and Shiprepairers Association has flagged the possibility that the United States may withdraw from the Agreement, and that the Agreement may even fail.

There had been an understanding among the participants to the Agreement that they would not, from the signing of the Final Act in late 1994, increase the level of existing support measures or introduce new measures, pending entry into force of the Agreement in July 1996. But given that the Agreement has yet to come into force, the status of this understanding is unclear.

### **3.3 Should Australia sign?**

Australia's decision on whether to sign the Shipbuilding Agreement will affect its future capacity to assist the domestic shipbuilding industry. If Australia signs the Agreement, then consideration of ongoing bounty support becomes irrelevant. If it chooses not to sign, reactivation of the bounty is possible. However, a decision not to accede to the Agreement would not be a 'green light' for ongoing bounty support — assistance to shipbuilding should stand or fall on its merits (see chapter 4).

Clearly, the decision about whether Australia accedes to the Shipbuilding Agreement (once implemented) should be based on an evaluation of the accompanying benefits and costs. However, it is not the Commission's intention in this submission to provide a definitive benefit-cost analysis. Rather, the Commission has identified areas which the Panel may wish to consider in its deliberations.

#### **Price considerations**

Assuming that implementation of the Shipbuilding Agreement led to a significant reduction in subsidies, there would be costs for Australian ship users, but benefits for ship producers. That is, Australian users of ships — both commercial and recreational — benefit from the current subsidies to shipbuilders around the globe. On the other hand, these same subsidies reduce prices for the Australian shipbuilding industry.

The net outcome of these two effects will broadly depend on whether the gains from higher prices in export markets are greater or less than the costs arising from higher prices for imported ships and shipping services. Thus, at first blush, Australia's decision on whether to sign the Shipbuilding Agreement might be

seen as a function of its balance of trade in ships. That is, if the value of exports exceeds that for imports, then it would be in Australia's interests to sign.

However, on closer examination, whether or not Australia signs may have little impact on the *price* outcomes. As a small shipbuilder, any assistance that Australia could provide if it failed to sign would have little overall impact on world prices (although there could be some effect in niche markets such as ferries). Similarly, a failure to sign is unlikely to leave the way open for continued importation of subsidised vessels — participation in the Agreement by the major shipbuilders would largely rule out this possibility.

Some might argue that Australia's lack of influence on world prices means that it can do better by not signing the Agreement. That is, while not having any significant effects on prices, Australia's non-accession would allow it to continue to support the local shipbuilding industry. In contrast, its competitors that sign the Agreement would have to terminate their subsidies. This in turn might be seen as giving the Australian industry an advantage in competing for business.

However, there are at least two flaws in this argument.

First, if the Agreement is ratified and Australia opted not to sign, it would almost certainly face increased scrutiny of any subsidies it continued to provide to domestic shipbuilders. Indeed, it appears that under the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures, bounties, while not prohibited, could be actionable if they were to displace imports or other exports into third markets (IC 1995a).

Second, as emphasised at the outset of this submission, consideration of assistance issues must have regard to economy-wide impacts. Thus, while non-accession to the Agreement might allow Australia to continue to support its shipbuilding industry, the benefits for the industry would need to be set against the costs imposed on other sectors of the economy (see chapter 4).

### **The anti-dumping provisions**

As noted above, the Shipbuilding Agreement provides for a sector-specific anti-dumping mechanism. This is based on the view that, as ships are not normally imported for sale, the GATT Anti-Dumping Code is not applicable. Whether this is in fact universally true is debatable. Were an Australian person or business to acquire an ownership interest in a vessel that is not imported — for example, an Australian ship operating overseas — then, under the current regime, it could be impossible to invoke a dumping complaint. But equally, some vessels are imported into Australia and could therefore be the subject of a

dumping complaint under our general anti-dumping procedures. Perhaps with this in mind, the Anti-Dumping Authority commented that the statement that the GATT Code does not apply to trade in ships is ‘too strong’ (BIE 1995).

That said, this part of the Agreement will almost certainly put upward pressure on vessel prices and thus reinforce the effects of an end to subsidies to shipbuilders.

### **Link to other trade policies**

The preceding discussion suggests that, if the Shipbuilding Agreement comes into effect, then Australia’s decision on whether to sign may have relatively little direct impact on either the domestic industry or our ship users. However, the case for signing is strengthened when consideration is given to the impact on other Australian industries of providing assistance to shipbuilding.

More broadly, the Commission notes that the thrust of the Agreement seems to be consistent with a range of other trade barrier reduction programs to which Australia is a signatory and with its stance on trade liberalisation in general. For instance, in recent years, Australia has:

- actively pursued wide-ranging unilateral tariff reductions — apart from improving domestic resource allocation, such actions have contributed to preserving the integrity of the multilateral trading system and set an example for others to follow (GATT 1994);
- committed to further reviewing its general tariff rates by 2000 under its Individual Action Plan in the Asia-Pacific Economic Cooperation forum;
- been a leading advocate for continuing reductions in assistance in multilateral fora — for example, the ‘Cairns Group’, incorporating 15 agricultural producing nations, was established to press for a global effort to reduce agricultural protectionism (DFAT 1995, 1997); and
- made commitments to reduce its barriers to trade in services (IC 1995b).

Thus, if the Panel were to find that Australia should not sign the Shipbuilding Agreement, it would need to clearly demonstrate why shipbuilding should be treated differently from most other parts of the economy, or that there are deficiencies with this particular Agreement.





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## 4 ASSESSING THE CASE FOR REACTIVATING BOUNTY SUPPORT

As already noted, for new orders, the shipbuilding industry is now effectively operating in a bounty-free environment. While the bounty does not terminate until mid-1999, in the interim it is payable only if a firm commitment for the construction or modification of a vessel was entered into by the end of 1997.

In the event that the OECD Shipbuilding Agreement enters into force in the near future, and Australia decides to accede to it, any question of resurrecting bounty assistance for the industry would become largely irrelevant. Rather, the issue would be whether there was any need for transitional or adjustment measures and, if so, their nature.

However, if implementation of the Shipbuilding Agreement is significantly delayed, or Australia decides not to participate, the issue arises as to whether reactivation of the bounty could be warranted. The Panel has indicated that it will be considering this issue (SIRP 1998).

Accordingly, this chapter considers some possible economic rationales for reactivating the shipbuilding bounty. Drawing on these rationales, it seeks to establish some thresholds against which any resurrection of the bounty would need to be assessed. The chapter concludes with a discussion of the pros and cons of providing transitional assistance if Australia accedes to the Shipbuilding Agreement.

### 4.1 An economy-wide view

The case for further support for Australia's shipbuilding industry should be assessed from an economy-wide perspective. As for any industry policy, the interests of the community as a whole, rather than those of a particular firm or sector, should be the predominant consideration.

While the benefits of the bounty to the shipbuilding industry are readily apparent, some of the effects on the wider community are less obvious. The most apparent are the imposts on taxpayers, including other Australian industries, of financing the bounty. But, as the BIE (1995, p. 29) recognised in its review, there are also wider costs:

... governments have to keep in mind that every Australian industry competes with all other Australian industries for the economy's resources of labour and

capital. ... It follows that a shipbuilding bounty will help shipbuilders compete against these other *Australian* industries.

In other words, in enhancing the ability of the shipbuilding industry to compete for resources, the bounty reduces the competitiveness of other Australian industries. Thus, increased activity and job opportunities in the shipbuilding industry encouraged by the bounty will come at the expense of activity and jobs elsewhere.

The BIE (1995, p. 30) went on to conclude that:

Taking proper account of ... [the] adverse effects on other industries, there is no reason to suppose that total production and employment can be easily increased by programs of industry assistance.

Indeed, it is widely accepted that the costs of assistance will usually outweigh the benefits to the recipient industry. That is, assistance will detract from, rather than enhance, Australian living standards.

Therefore, to substantiate a case for resurrecting the bounty, evidence would be needed that shipbuilding has special features which mean that markets alone will not deliver the best outcome for the community. In this context, it is not sufficient simply to establish that, in the absence of the bounty, a dynamic, innovative and export-oriented industry would find it more difficult to compete on the international market.

## **4.2 Rationales for reactivating shipbuilding assistance**

Despite the costs which assistance to one industry or activity imposes on others, there are some circumstances in which government support may provide overall benefits to the Australian community. Assistance may sometimes be warranted to compensate for the adverse effects of other government policies. It may also be justified if there are significant 'market failures' associated with an activity. Alternatively, it may be a way of meeting regional or other social objectives.

This section briefly considers the applicability of these arguments to the shipbuilding industry.

### **Compensating for assistance to other Australian industries**

In the past, governments have assisted some industries partly to compensate for the adverse effects of the assistance provided to other domestic industries. Where other assistance arrangements cannot be altered, compensating support

may sometimes improve community wellbeing by preventing the relocation of resources in less efficient activities.

In recent years, nominal assistance afforded the shipbuilding industry by the bounty has been little different from the manufacturing average.

However, this conceals the fact that the bounty and related arrangements have in fact provided more generous support than that available to most other manufacturing industries (see chapter 2). In particular, tariff protection for other industries provides assistance only for domestic sales, whereas the shipbuilding bounty also applies to exports. In addition, the industry has benefited from special arrangements giving it wider access to duty-free imported materials and components than most other industries. In its review, the BIE (1995) argued that with tariffs generally at rates of 5 per cent or less, a lower rate of bounty (2 or 3 per cent) would provide assistance to shipbuilding more in line with the rest of the manufacturing sector.

Moreover, since the BIE review, other production bounties have ceased, a range of government business programs have terminated or been reduced, and the Government has committed to reviewing general tariff rates by 2000 under its APEC Individual Action Plan.

Thus, the bounty rate required to offset the impacts of assistance provided to other activities would now be much lower than 5 per cent, and would fall further as assistance elsewhere in the economy continues to decline. Whether it would be sensible to reintroduce the bounty at such a very low rate is debatable, particularly given the accompanying compliance costs for the industry, administrative costs for government and the efficiency costs of raising revenue to pay for the bounty (see section 4.3).

### **Compensating for assistance provided by other countries**

The Panel's terms of reference place a heavy emphasis on the assistance arrangements of competing countries. There is no question that world shipbuilding markets are distorted by assistance provided by overseas governments (see chapter 2). Its prevalence is the primary motivation for the OECD Shipbuilding Agreement. This assistance hinders market access for Australian shipbuilders and reduces prices in the domestic and export markets.

However, it does not automatically follow that, just because some other countries provide subsidies, Australia should do likewise.

The provision of assistance by other countries' governments is no more a 'market failure' than those countries enjoying lower costs because, say, labour is

cheaper. In effect, the subsidised world price — provided it continues — sets the opportunity cost for Australia of devoting resources to shipbuilding.

Moreover, for a small country like Australia, a general policy of compensating industries for the effects of overseas assistance across all traded goods would be financially unsustainable. It would be less financially demanding for Australia to be selective and only compensate particular industries, such as shipbuilding. However, this would simply penalise other efficient Australian industries.

Thus, a better policy will generally be to seek to have other countries' assistance removed through multilateral arrangements (such as the OECD Shipbuilding Agreement) and, in the interim, use our resources to the best possible advantage in the constrained environment. A more detailed explanation of the reasoning underlying this approach is provided in the Commission's latest annual report (IC 1997).

That said, there may be a case for short-term support if foreign subsidies are temporary and expected to be in place for less than the industry's investment horizon. In such cases, assistance may avoid the 'double adjustment' costs which may otherwise be incurred. The decision would rest on weighing the cost of providing the support against the benefits from avoiding the transitional costs.

But 'corrupt' prices and the underlying subsidies to shipbuilders are longstanding. Moreover, given the slow progress with the Shipbuilding Agreement — negotiations commenced in 1989 — and the continuing doubts regarding ratification by the United States, these distortions could conceivably remain for some time yet.

In any event, Australia has already terminated bounty assistance for new vessels. Hence, decisions on the future scale of activity in the industry may already have been taken on the basis of no bounty support. This raises the question of whether reintroduction of the bounty may be too late to avoid any double adjustment costs.

Similar considerations suggest that any decision to further delay termination of current support measures for the Australian shipbuilding industry should not be conditional on what other countries do. Waiting for other countries to act could make sense only if it encouraged others to reduce their subsidies faster and sooner. This does not seem likely, as Australia is a small player in the international shipbuilding industry (see box 4.1). And even if it did encourage quicker action overseas, the benefits would need to be weighed against the costs to Australia of continuing assistance to the shipbuilding sector.

**Box 4.1: 'Reciprocity' in assistance reductions**

One argument which has gained currency in the assistance debate is that Australia should only reduce its assistance further if, and when, other countries reduce theirs. Some advocates of 'reciprocity' also argue that Australia could do better by using its remaining assistance as 'negotiating coin' in trade reform deals with other countries.

It is conceivable that some hypothetical negotiated outcomes could produce a better result for Australia than if it were to continue to reduce trade barriers unilaterally. A deal which gave preferential access to Australia's car market to Japan and South Korea in return for preferential access to their highly protected agricultural commodity markets is one example. Because Japan and South Korea are efficient car makers, giving them preferential access to our market would provide much the same gains for Australian consumers and pressure for efficiency improvements in our car industry as reducing tariffs against all countries. And as an efficient primary producer, preferential access to the Japanese and South Korean commodity markets could see Australia capture considerable market share at the expense of other exporters.

But the likelihood of such deals also needs to be considered. The international experience has been that smaller trading nations possess limited bargaining power. This suggests that, in any practical sense, Australia may well be limited to sector-by-sector deals with other small trading nations. The potential benefits from such deals would be commensurately smaller. Yet the costs of compromising the domestic reform program may remain largely the same.

Moreover, the form of support to the shipbuilding industry in Australia and overseas makes it even less likely that worthwhile deals could be struck. The negotiating coin argument is usually couched in tariff terms. Hence, a deal would involve securing better access in export markets in return for reducing barriers to the negotiating partner in the domestic market. But in the shipbuilding industry, our negotiating coin (and that of many other countries) is a production subsidy (bounty). Removing these subsidies on exports to particular markets as part of a negotiated deal would reduce competitiveness against all competitors in those markets, not just the negotiation partners. Thus, such deals could leave the participants even more exposed to the effects of subsidies from third countries.

These considerations underscore the rationale for a multilateral approach to reform as reflected in the OECD Shipbuilding Agreement. However, this is not to deny the benefits to Australia from separate unilateral reform (see text).

More generally, the Commission notes that, for the economy as a whole, domestic assistance reform has a much greater impact than trade liberalisation by other countries, even with the much lower tariff rates now applying in Australia. For example, more than four-fifths of the estimated gains to Australia from trade liberalisation in APEC come from domestic reform (IC 1997). Hence, waiting for other countries to liberalise generally serves to delay the (larger) benefits that flow from unilateral action at home.

## **Externalities**

Virtually all economic activities have flow-on effects for other activities. Many of these flow-ons are positive. Others are not, but are still widely accepted as desirable outcomes of the competitive market process. For example, the entry of a new firm to an industry will increase competition for other firms, and may even result in some closing down. However, the community usually gains through access to cheaper and/or higher quality products. Importantly, in such cases, the benefits and costs are reflected in market outcomes, with the new firm succeeding only if it offers products which are better value for money.

Sometimes, however, the activities of a firm or industry have effects on others which are not properly reflected in market transactions. Without government intervention, these ‘externalities’ or ‘spillovers’ can lead to under- or over-provision of the activity concerned. Research and development (R&D) is the prime example of an activity with substantial positive externalities and for which significant government support is warranted (IC 1995c).

But apart from R&D, the Commission considers that the externality rationale for government assistance is typically overstated.

In this context, externalities are often confused with economic *multipliers* generated by an activity. Multipliers are summary measures of linkages between activities: for instance, the number of jobs that an expansion in shipbuilding exports will create in supplier industries. But if this induced activity involves bidding resources away from other industries, then there will be offsetting negative multiplier effects — such as reduced job opportunities in those industries. That is, all activities (and alternative uses of government funds) have multiplier effects. This is why assessment of the shipbuilding bounty must have regard to its effects on the economy as a whole, rather than simply on the shipbuilding and supplier industries.

The Review of Business Programs (Mortimer Review) (1997) also sought to extend the definition of externalities beyond the conventional interpretation. In particular, it applied the concept to policy actions by foreign governments which

are detrimental to Australian industries. However, for the reasons explained above, assistance provided by overseas governments is not a compelling rationale for the Australian Government to do likewise.

An externality argument of potential relevance to shipbuilding is that the industry's export success may contribute to developing export markets for other activities. Clearly, some pioneering firms may help to establish Australia's reputation in overseas markets and provide market intelligence to other local firms.

However, to justify the bounty on these grounds, the Panel would need to demonstrate that such spillovers:

- apply to all shipbuilding exports — otherwise a bounty on all exports would be an inefficient mechanism to address the spillovers;
- are of benefit to other industries — if not, the spillovers would be internal to the shipbuilding industry and could be addressed, for example, by an industry levy to fund export market development;
- are sizeable; and
- are not addressed by more widely available export programs.

Similar tests would also be applicable to any argument that shipbuilding provides technological spillovers for other industries. That is, the Panel would need to establish that shipbuilding is R&D-intensive and produces new technologies of substantial benefit to other industries. Moreover, it would also need to establish why general government support for R&D (such as the 125 per cent tax concession and the START program) would not address any such spillovers. The Commission notes that, in its review, the BIE (1995, p. 42) specifically rejected any externality argument in relation to the shipbuilding industry:

It has not been suggested by the shipbuilding industry that it provides external benefits to other industries, nor have we found any evidence that it does so on a significant scale. It is an efficient and technically advanced industry but it is not an R&D-intensive industry of the kind that is likely to produce new technologies that will be of significant benefit to other industries. And the basic skills in the industry — in engineering and design, metal-working, project management and business management — do not distinguish it in any significant way from many other manufacturing industries in Australia.



## **Other rationales**

### *Catalyst for change*

Government support is often seen as having a catalytic role in improving an industry's performance. According to this argument, well-targeted support can encourage firms to participate in export markets and to adopt up-to-date technology and better management practices.

As discussed in chapter 2, during the 1980s, the shipbuilding industry transformed from one with a focus almost entirely on domestic markets to one heavily oriented towards exports. The extension of the bounty in 1984 to cover vessels built for export no doubt facilitated this transition, particularly given the significant rate of bounty payments at that time.

But any role for the bounty as a catalyst for change could not continue to have force indefinitely. Indeed, in recent years, the industry has increased its export orientation even as its assistance has fallen to much lower levels. Australian shipbuilders are now strong players in niche markets, with exports accounting for more than 90 per cent of lightweight vessels completed in 1996–97. To a large extent, the industry's success has been founded on innovative design and the latest technology. It would therefore seem difficult to argue that a bounty of 5 per cent is still required for catalytic reasons.

### *Regional development*

Another possible justification for ongoing bounty support is as a means to promote regional development.

In 1996–97, more than half of total bounty payments went to shipbuilders in Perth, with a single producer in Hobart receiving almost 40 per cent. Only 2 to 3 per cent of bounty payments assisted shipbuilding outside the capital cities.

Moreover, even in Hobart, the amounts involved (bounty payments of around \$9 million in 1996–97) must be viewed in the context of a regional economy of some \$4 billion. And while unemployment in Tasmania continues to exceed the national average, the shipbuilding industry accounts directly for just 0.2 per cent of the State's employment.

Further, because the bounty is payable to all qualifying shipbuilders irrespective of location, it is inevitably an imprecise and uncertain way of helping particular regions. Therefore, if the government does wish to support particular shipbuilding regions, the Panel would need to explain why this would not be better pursued through explicit regional development measures rather than

through a general, and therefore non-targeted, subsidy to shipbuilding production.

### 4.3 Further considerations

The above discussion points to some substantial threshold questions that the Panel should consider in assessing whether there is a case for further government assistance to the shipbuilding industry. Central to such an assessment would be establishing a compelling rationale for support and substantiating net benefits to the economy as a whole from any assistance provided. Addressing these questions would accord with the preferred approach of the Mortimer Review that business programs must address market imperfections and provide demonstrable net economic benefits.

Several additional issues are relevant to the assessment:

- *Other government assistance:* Does the industry's access to more general government programs such as EFIC, and to State government assistance, address any perceived rationale for assisting shipbuilding?
- *Administrative and compliance costs:* Analysis in the Commission's latest inquiry into book printing (IC 1996) suggested that the benefits from the book bounty were substantially offset by its administrative and compliance costs. This may be less of a problem for the shipbuilding bounty, given the much smaller number of claimants and the higher average payment. But it would become increasingly important at lower bounty rates.
- *Costs of raising government revenue:* As noted earlier, the additional tax revenue necessary to pay for the bounty is an impost on other sections of the community. But this impost is not simply a transfer to the shipbuilding industry from other taxpayers. Raising taxes also has efficiency costs. For example, the Commission's microeconomic reform stocktake (PC 1996) reports evidence that the efficiency costs of revenue raising via income tax could be more than 20 cents for each dollar raised.

In summary, even if specific support for shipbuilding can be justified in principle, it should only proceed if the underlying problem is not already addressed by other programs and if the potential efficiency gains are greater than the efficiency costs of administration, compliance and financing.

#### 4.4 Transitional assistance issues

In the event of implementation of the OECD Shipbuilding Agreement and Australia's accession to it, the Panel has been asked to consider whether transitional arrangements are warranted and to report on possible options.

Transitional arrangements could involve some form of adjustment assistance or a further period of specific support to shipbuilding, such as a (further) *temporary* extension of the bounty. The Shipbuilding Agreement automatically permits some forms of adjustment support — for example, assistance to redundant workers. But for forms of assistance not generally permitted — for example, subsidies — such provision would have to be negotiated as part of Australia's accession to the Agreement.

In its industry inquiries and annual reports, the Commission has argued that there will be circumstances where specific adjustment measures are warranted on efficiency and/or equity grounds. It has therefore typically recommended phased rather than abrupt assistance reductions, particularly where initial assistance levels are high.

However, a number of factors militate against the provision of adjustment assistance for the shipbuilding industry:

- With the Shipbuilding Agreement being concluded in 1994, the industry has had a long period of notice about Australia's possible accession.
- Provided the Agreement is effective, the removal of subsidies would lead to higher vessel prices. For Australian shipbuilders, these price increases could quite possibly more than offset the removal of the bounty.
- The Australian industry has already had a generous phasing program for its bounty assistance. Reductions in the bounty have been proceeding since 1988. Moreover, the industry was put on notice then that the bounty would cease no later than 1995. But, despite the termination of all other bounty assistance, shipbuilders have already benefited from three reprieves during the 1990s (see chapter 2).
- The level of assistance provided by the bounty is now much lower than a decade ago. The adjustment pressures facing the industry from the removal of the bounty should therefore be much more manageable. Indeed, in terms of the industry's competitiveness, the bounty would seem to be relatively insignificant when compared with non-price factors such as advanced design and leading-edge technology.
- Shipbuilders would continue to have access to support through EFIC's export credit arrangements, which are consistent with the Shipbuilding Agreement.

- Any retrenched workers in the industry would have access to general retraining programs and support.

Having regard to similar considerations, the BIE review (1995, p. 42) rejected the case for specific adjustment assistance for the shipbuilding industry:

Given that the light-weight/high-speed industry has been growing strongly for at least a decade, and that it has good prospects for growth in the foreseeable future, it cannot be argued that assistance is required to ease problems of adjustment to declining competitiveness. That thinking partly motivated the introduction of the original export bounty scheme, specifically, to assist the process of restructuring and structural adjustment in the traditional steel-based shipyards. But that process is now behind us, and, in any event, it was the new light-weight/high-speed industry that gained most from the scheme and there is virtually no continuity between the new and old industries.

In any event, for new orders, the industry is already operating in a bounty-free environment. Given this, a decision to provide specific adjustment assistance would represent a significant policy reversal. It could also provide a windfall gain to firms which have already adjusted their operations to reflect the end of bounty support.



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