CARR'S CAR CASH AND AUSTRALIA'S REFORM MALAISE

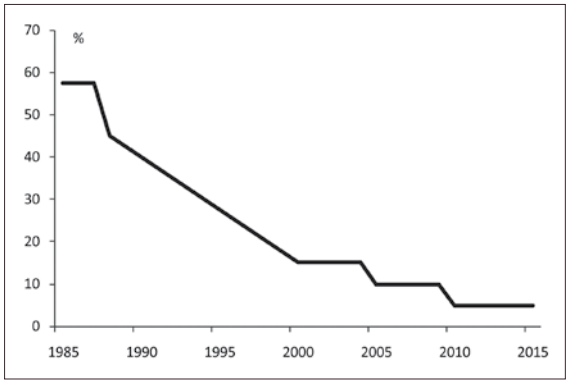
Australia should end automotive industry assistance, argues **Gene Tunny**

On 20 June 2008, based on a Freedom of Information release from the Treasury, *The Australian* reported 'The Rudd Government overruled a push by Treasury to stop the Bracks review of the automotive industry from considering an extension to controversial financial assistance for car makers.'[1] The review, led by Steve Bracks, itself was controversial because originally it was expected to go to the Productivity Commission, rather than to a former Premier of Victoria, the state with the largest automotive industry. Hence, the report in *The Australian* was an early warning that Australia's heavily subsidised automotive industry would continue to receive government financial support beyond the 2015 cut-off date established in 2002.

Broadly as anticipated, in November 2008 the Rudd government increased financial assistance to the automotive industry to $6.2 billion over 2008-09 to 2020-21, with $3.2 billion of new funding, including an expansion of the government's Green Car Innovation Fund from $500 million to $1.3 billion.[2]

At the same time as boosting financial assistance, the government confirmed it would not repeal or delay the scheduled cut in the automotive tariff rate from 10% to 5% on 1 January 2010. Hence, the government maintained the downward trend in the tariff rate since the mid-1980s, when the tariff rate was nearly 60% (Chart 1).[3] Historically, the tariff on passenger motor vehicle imports was the major assistance measure for the automotive industry (in combination with import quotas, which were abolished in the mid-1980s).

Chart 1: Automotive tariff rate



Source: Customs website and Parliamentary Library.

As a result of the *New Car Plan*, the balance of the two types of assistance—direct financial support and tariffs—is further shifting towards financial support. As tariffs have come down, Australian governments have provided so-called 'transitional assistance' to the industry. This has

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resulted from a reform process that has involved intense negotiations between governments, the automotive industry, and unions, with outcomes that are not necessarily in the national interest.

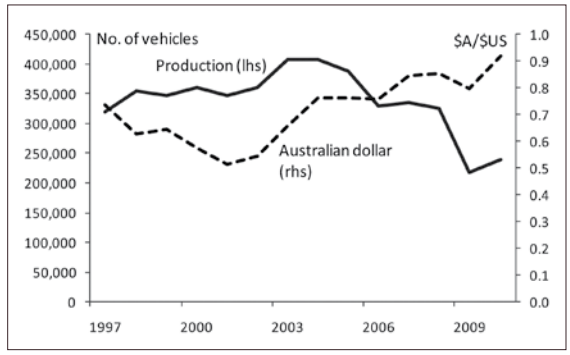
Overview and recent trends

As tariffs have declined since the mid-1980s, Australia has gone from having five car manufacturers assembling 13 models in eight plants to three manufacturers assembling six models (Falcon, Territory, Commodore, Cruze, Camry, and Aurion) in three plants.[4] The total automotive industry, comprising motor vehicles and parts production, employs around 55,000 people, or only around 0.5% of the workforce.[5] The industry, however, is heavily concentrated in Victoria and South Australia, particularly in Geelong in Victoria and Elizabeth in South Australia. Hence, any reductions in industry assistance could result in relatively large job losses at a regional level if they affect the financial viability of particular automotive manufacturers.

The ongoing financial viability of many automotive industry participants remains in doubt. The Bracks review recommendations were framed in the context of a rising Australian dollar due to the mining boom and recognition that without government support the car industry at its current scale is not viable. Indeed, in early February 2008, not long before the Bracks review was commissioned, Mitsubishi announced it would cease production in Australia, leaving just three domestic car makers: GM Holden, Toyota and Ford. With the ongoing viability of Ford in question, some industry observers say Ford may be the next Mitsubishi.[6]

Australia's three car manufacturers, which are all foreign-owned-subsidiaries of their parent corporations, produced just under 240,000 motor vehicles in 2010. This was considerably lower than approximately 400,000 seven years ago, largely due to the impact of the higher Australian dollar on sales and hence production (Chart 2). The share of total domestic sales for the Australian car manufacturers has fallen from around 30% a decade ago to less than 15% today, and manufacturers are relying more on export sales—Toyota to the Middle East and Holden to the United States.[7] Australian car manufacturers will soon come under pressure from China, which recently became the world's largest producer of automobiles.[8]

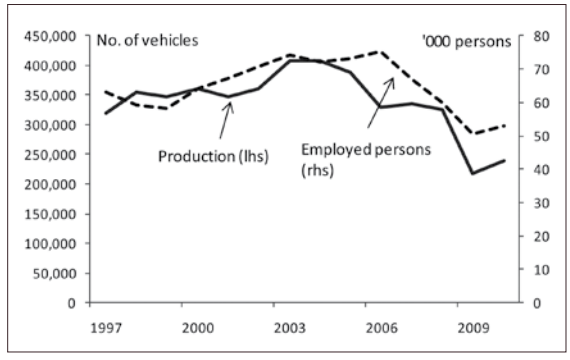
Chart 2: Local production of motor vehicles



Source: DIISR (2010) and RBA.

As production has fallen over the last five years, so has the level of employment in the industry (Chart 3). The annual-average employment level has fallen from around 80,000 in the mid-2000s to around 55,000 in 2010.

Chart 3: Automotive industry employment trends



Source: DIISR (2010) and ABS.

Despite the high exchange rate, based on industry production and employment numbers (Chart 3), the Australian automotive industry picked up somewhat in 2010 compared with the late 2000s, but the future remains uncertain. For example, sluggish sales of the new Falcon raise questions about Ford Australia's future

investment plans. Falcon sales are down from more than 73,200 in 2003 to 29,500 in 2010.[9] On 14 April 2011, Ford Australia announced it would cut 240 jobs as it reduces vehicle production to match lower demand.[10]

In addition to the three car manufacturers, the industry includes 200 parts manufacturers; as part of the supply chains for the industry, such firms are under threat from the reduced demand for Australian-made cars.[11] An early indication of the difficulties faced by firms in the supply chain came with the financial troubles of Tasmania's ACL Bearings, the sole supplier of precision auto bearings to Australia's car manufacturers. In 2008, ACL Bearings received special assistance of $2 million from the Commonwealth government and $330,000 from the Tasmanian government to keep its business operational.[12] In June 2009, Innovation and Industry Minister Kim Carr announced a further $7 million to ACL Bearings from the federal Automotive Industry Structural Adjustment Program, part of the *New Car Plan*.[13]

Government assistance

The Australian government assists the automotive industry in two main ways: the 5% tariff on passenger motor vehicles (and parts) and budgetary support through the Automotive Transformation Scheme (ATS), the Rudd government's revamp of the Howard government's Automotive Competitiveness and Investment Scheme (ACIS). Additionally, the government is providing significant support through the Green Car Innovation Fund.

According to Productivity Commission estimates, the car industry received more than $1.6 billion in 2009–10 ($721 million in budgetary assistance and $903 million in tariff assistance).[14] With around 55,000 workers in the industry, this amounts to around $29,000 per worker per year (approximately $13,100 in budgetary support and $16,400 in tariff support per worker) and is a significant diversion of resources from more productive uses.

The dollar value of tariff assistance is not the revenue raised by the tariff, but the commission's estimate of the net benefit of the tariff to the industry, which is technically known as the net subsidy equivalent.[15] The estimated tariff assistance of $903 million in 2009–10 was based on the then most-favoured-nation automotive tariff rate of 10%, applying in calendar year 2009, and 5% in calendar year 2010. With the lower tariff rate of 5% applying in 2010–11 and later financial years, the level of tariff assistance is likely to fall in 2010–11, potentially to under $800 million. It is however difficult to forecast the future level of tariff assistance because there may be a demand response associated with the tariff rate reduction, with people buying more imported cars due to the lower tariff rate. So, although the tariff rate is lower, it would apply to more imported vehicles, which would offset the reduction in assistance to some extent due to the lower tariff rate.

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As tariffs have fallen, the balance between tariff assistance and budgetary assistance is changing, with the latter becoming more prominent. Unfortunately for the quality of public debate and scrutiny, the extent of government budgetary assistance to the automotive industry and its intended role as transitional assistance (and to fund specific innovation programs with a limited life only), rather than as an ongoing subsidy, is not well understood.

The Howard government's ACIS assistance, which commenced in 2001, was supposed to end in 2015, after the level of assistance over 2011–15 was substantially reduced compared with 2005–10. The assistance, after all, was meant to aid the industry's transition to the lower tariff rate. Given that the tariff reductions would cease in 2010, it appears the additional five years of assistance to 2015 was viewed as sufficient to aid this transition when the Howard government announced the post-2005 assistance arrangements in December 2002.

In its first two stages (2001–05 and 2006–10), ACIS delivered around $5.5 billion in financial assistance to the automotive industry. ACIS, which was a revamp of the former Export Facilitation Scheme and its emphasis on transitional assistance, innovation and R&D, was largely driven by the need to avoid a violation of World Trade Organization (WTO) rules that prohibit export subsidies. In complying with WTO rules, ACIS ended up with a very complicated design, and this has carried over to the ATS.

ACIS involved both a capped component (for production and investments in plant, equipment and R&D) and an uncapped component based on vehicle production. Because the capped component would be over-subscribed, with dollar claims by the car industry exceeding the total amount available each year ($400 million per annum over stages 1 and 2), the assistance had to be modulated, that is, scaled down to match the money available.

In designing the ATS, the Rudd government largely followed the recommendations of the Bracks review and took the ACIS framework, tweaked the formulas for calculating assistance (for example, providing a slightly higher rate of subsidy for R&D while reducing the number of eligible activities), and converted the payments mechanism from import duty credits to cash payments.[16] The shift to cash payments mollified car makers and parts manufacturers, who were concerned that with the lower automotive customs duties associated with the tariff rate reduction to 5%, they may have been left with ACIS duty credits they could not offset against customs duties or sell into the secondary market for ACIS duty credits.

In addition to modifying ACIS's design, the Rudd government significantly boosted financial assistance to the industry as part of the ATS, including an additional $500 million in capped assistance that would not have been available under ACIS Stage 2 (2011–15) and a new tranche of assistance of $1 billion from 2016–20 (see Table 1 for a comparison of assistance available under ACIS and the new ATS. At the same time as it boosted the capped assistance, the government tweaked the formula for uncapped assistance, which now runs out slightly longer to calendar year 2017, compared with 2015 under ACIS Stage 3, at a broadly comparable budgetary cost of around $800 million–$900 million. However, it is very difficult to forecast the uncapped assistance as it is based on actual production; the actual amount paid by the government may be much lower (or much higher if, in contrast with current trends, the industry thrives over the next decade).

As part of its *New Car Plan*, the government also provided structural adjustment assistance (around $116 million) and boosted its Green Car Innovation Fund from $500 million to $1.3 billion. Payments have been made under the fund to both car and parts manufacturers,

Table 1: Comparison of ACIS Stage 3 and ATS financial assistance to the automotive industry

	ACIS Stage 3	ATS
2011–15	**Capped assistance** of $1 billion **Uncapped assistance** of around $800 million	**Capped assistance** of $1.5 billion **Uncapped assistance** of around $700 million
2016–20	–	**Capped assistance** of $1 billion **Uncapped assistance** of $100 million–$150 million over 2016 and 2017

Source: DIISR (2008) and *Innovation, Industry, Science and Research Portfolio Budget Statement* (2010–11), 30.

with the largest payments going to GM Holden for developing Holden Cruze ($149 million), Toyota for developing new engines ($63 million), Hybrid Camry ($35 million), and Ford for developing the EcoBoost engine for the Falcon ($42 million).[17]

The $1.3 billion commitment to the Green Car Innovation Fund was obviously viewed by some members of the government as excessive, and was cut by $200 million in the 2010–11 Budget, before closing it entirely in January 2011 to ease budgetary pressures caused by the 2010–11 summer floods and Cyclone Yasi. The final payments from the fund are expected to total $500 million, which was the government's intention before the *New Car Plan*.[18]

The merits of the Green Car Innovation Fund were always questionable, and it has arguably not provided much additional innovation. For example, on 11 June 2008, *The Australian* reported, 'Car giant Toyota had already decided to make a hybrid version of its Camry sedan in Australia and did not need the $70 million of taxpayer funded subsidies promised by the federal and Victorian governments yesterday.'[19]

The government also provides some protection to the domestic car industry through a tariff on imported used cars, although this also benefits foreign carmakers exporting new cars into Australia. The $12,000 tariff on imported used cars, with exceptions only for specialist enthusiast vehicles, denies Australians access to the cheap imported Japanese cars that our cousins in New Zealand enjoy. For example, a six-year-old Toyota Corolla with around 100,000 kilometres on the odometer sells for around $A10,800 in New Zealand compared with $13,100 in Australia (Table 2).

Future trends in industry assistance

In its annual *Trade and Assistance Review*, the Productivity Commission includes estimates of the effective rate of combined assistance from tariff and budgetary support to industries. This is calculated as the sum of budgetary and tariff assistance divided by the estimated value of production in the sector (if there were no assistance). This estimate indicates how much higher the returns to an industry are, in terms of value added, due to the assistance. For the automotive industry, in 2009–10, the commission estimated this rate at just over 11%.[20]

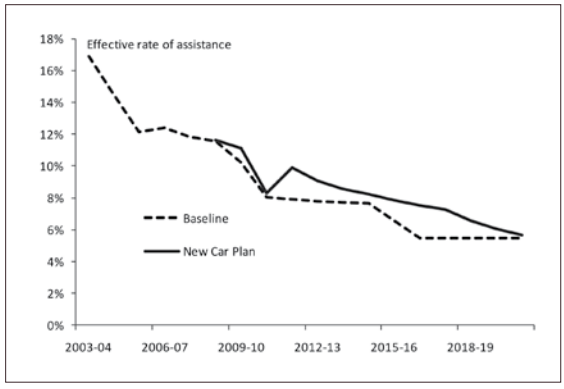
Taking into account the new ATS and the $500 million to be paid out of the now-closed Green Car Innovation Fund, the Gillard government has committed nearly $2 billion of extra assistance to the industry (2011–20), which equates to nearly $200 million per annum. This will have a significant impact on the rate at which assistance to the industry will decline (Chart 4), and hence delay the adjustment or rationalisation of the industry, which is inevitable given the automotive industry's unviable state.

Table 2: Examples of prices for second-hand Toyota Corollas (auto, hatchback, 2006 model) in Australia and New Zealand

	Australia		New Zealand		
Examples	Kilometres	Price ($A)	Kilometres	Price ($NZ)	Price ($A)
1	93,000	13,500	94,072	16,999	12,688
2	98,000	13,500	97,980	15,999	11,941
3	106,000	12,000	103,170	13,700	10,225
4	110,000	12,900	110,061	11,500	8,583
5	114,782	13,500	112,200	13,995	10,446
Average	104,356	13,080	103,497	14,439	10,777

Source: Australia: www.carsales.com.au; NZ: www.autotrader.co.nz (as on 25 April 2011).
Note: $A1=$NZ1.3398 (exchange rate reported by RBA on 25 April 2011).

Chart 4: Effective rate of assistance



Source: Author's estimates based on Production Commission and DIISR data.

Over the 10 years from 2009–10, the *New Car Plan* raises the effective rate of assistance by around 1.2 percentage points on average, and while government assistance would have previously come down to around 5.5% by 2016–17, it is likely to remain around 7.5% for a couple of years after 2016–17. These estimates depend on production figures, which are difficult to forecast.

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Ultimately, the amount of assistance, particularly the uncapped ATS payments, will depend on industry developments, for example, whether all three car manufacturers remain in Australia. However, even if there is a major rationalisation of the industry in the next decade, and uncapped ATS payments fall, there may be increased pressure on the government for structural adjustment assistance, including support for the retraining of workers.

Further, there is no guarantee that, as the expiry of current ATS assistance approaches in the late 2010s, the government of the day will not commit to further transitional assistance beyond 2020. An extension of industry assistance is likely based on previous experience—in 2002, the Howard government extended ACIS to stages 2 and 3, and in 2008, the Rudd government further extended assistance to 2020. Hence, while the effective rate of assistance is expected to go back toward what it would have been in the absence of the *New Car Plan* by the late 2010s, this is by no means guaranteed.

Policy choices

The ability of politicians to take tough decisions regarding the automotive industry is doubtful, with their romantic attachment to manufacturing in general and automotive manufacturing in particular. For example, former Prime Minister Kevin Rudd famously declared he wanted Australia to be 'a country that actually makes things.'[21] And the Innovation Minister highlighted the car industry's role in encouraging innovation without explaining why this requires a massive amount of government assistance in addition to the existing R&D tax concession, the government's key policy tool to promote innovation.[22]

Australian governments have historically increased financial assistance and are maintaining the $12,000 tariff on imported used cars despite falling tariffs. This is an excessive and arguably regressive policy measure that has remained in place because of a view that removing it would unnecessarily disrupt the orderly transition of the industry to lower tariffs and lower levels of assistance. This was the position of the Productivity Commission in 2002, but this position was based on financial assistance eventually coming to an end no later than 2015 and preferably by 2010.[23] Given assistance is now being extended beyond 2015, the government should consider reducing the used-car tariff.

Although reduced tariffs are expected to be beneficial for consumers when considered in isolation, it is possible that government deals with the automotive industry (and unions) for policy packages are, on balance, resulting in limited efficiency gains or even losses. Any gains from tariff reductions may be offset by the adverse impacts of boosting financial assistance to the industry and keeping the $12,000 used-car tariff.

The Productivity Commission could only estimate relatively small economic gains—of around $600 million per annum or 0.06% of

GDP—from the reduction of the automotive tariff rate from 10% to 5%.[24] The small efficiency gain was due to two reasons. First, at 10% the tariff was already relatively low and the large gains from tariff reduction had already occurred as it had fallen from a high of 57.5% in the mid-1980s to 10% in 2005. Second, the automotive tariff only protected one relatively small sector of the economy.

Ex-Productivity Commission economist and independent consultant Nicholas Gruen argues Australia would have been better off keeping the automotive tariff at 10%, given the potentially adverse consequences from cutting it.[25] At 10%, it may have become a so-called optimal tariff, which is a positive tariff rate that improves community wellbeing and can be demonstrated in theoretical and econometric models under certain conditions.

An optimal tariff hinges on a technical assumption regarding the extent of Australia's market power in its export markets, such as wheat. For example, by assuming the world price for wheat would fall if Australia exported more, a reduction in the automotive tariff rate could, theoretically, have an adverse impact on our terms of trade. This is because, if tariffs fall and we import more (assuming the balance of trade remains constant), Australia would have to export more goods and services. This could happen if Australia produced and exported more wheat at a lower price. It turns out that, if the export price falls far enough, there could be a negative impact on the wellbeing of Australians from a tariff cut.

In response to the commission's modelling report of May 2008, which found small gains from tariff cuts, there was a series of technical exchanges between the commission, Gruen and the Centre of Policy Studies at Monash University, which must have left policy advisers bemused that economists could not agree on the merits of a tariff cut being good policy. Nonetheless, the optimal tariff debate was illuminating. The debate showed that the economic gains from cutting the automotive tariff further were small—given the tariff was already at a low level—and could disappear under certain conditions. As such, in hindsight, it is arguable that participants in the policy debate should have paid less attention to the tariff rate issue. Instead, they should have paid more attention to the proposed expansion of financial support and the maintenance of the $12,000 used-car tariff.

If the compensation to the automotive industry for cutting the tariff rate to 5% was a boost in financial support and the maintenance of the $12,000 special duty on imported used cars, an alternative policy package may have been more desirable from a community welfare point of view. Of course, pursuing the first best policy—cutting the tariff rate, ending financial support, and removing the $12,000 used-car tariff—would be most desirable. Unfortunately, automotive industry policy is clearly second best, third best, or worse, and it is unclear whether the government picked the right policy package. For example, Australia may have been better off with a more gradual transition to a 5% tariff rate, lower levels of financial support for the industry, and the removal of the $12,000 used-car tariff. This would make for a very useful empirical investigation by a skilled economic modeller.

Cutting the tariff rate, ending financial support, and removing the $12,000 used-car tariff would be most desirable.

Conclusion

In 1997, Ross Garnaut, former economic adviser to Prime Minister Bob Hawke and now key climate change adviser to the Gillard Government, lamenting the 'reform malaise' in Australia, said reforming the automotive sector could make an important contribution to ameliorating that malaise.[26] In 2011, the malaise is still present, and the potential for automotive sector reform to lifting that malaise is still significant.

Given the large amounts of financial assistance to the industry over the years—more than $5 billion in the 2000s alone—and the heavy rate of subsidy per job it entails, the government needs to clearly signal it will not provide any more assistance beyond 2020, when the ATS funds run out. It would also make itself highly popular with motorists, particularly struggling students, if it lifted the $12,000 tariff on used cars.

No longer should the government give in to the excessive demands of global automotive corporations that are playing governments against each other to extract the best subsidies. The demands for corporate welfare are never ending, and automotive corporations will always be able to apply pressure on governments for further assistance by suggesting they could relocate to a more accommodating country. For instance, industry participants have suggested that, with the closure of the Green Car Innovation Fund, they may be tempted to look overseas with better subsidies.[27]

With current policy settings, the government is delaying the inevitable adjustment that will occur if the dollar remains high and the Chinese car industry expands into new markets. The government needs to consider what structural adjustment assistance it will need to provide to the industry, including possibly the pre-emptive retraining of automotive industry workers for new employment opportunities elsewhere.

The government has taken the first step to ending automotive industry assistance by ending the Green Car Innovation Fund. It is time for the government to make good on its commitment to reform and to signal the end of financial assistance to the industry for good.

Endnotes

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