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ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of South-East Asian Nations (comprises Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand)
CAP	Common Agricultural Policy (European Community)
EC	European Community (comprises Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and United Kingdom
EPZ	Export Processing Zone
GATT	General Agreement on Tariffs and Trade
GDP/GNP	Gross domestic product/Gross national product
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development (comprises Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Norway, Portugal, Sweden, Switzerland, Turkey, United Kingdom, and United States)
R&D	research and development
SME	small-and medium-sized enterprise
TRIM	Trade-Related Investment Measure
VAT	value-added tax

I INTRODUCTION

The Commission's terms of reference ask that it give specific attention to the methods by which Australia's main trading partners promote exports; and to the effects of these measures on the promoting economies and on Australia. This volume examines the export enhancement measures used in 13 economies.

The eight Asian economies which the Commission visited are examined first, followed by New Zealand, the United States and finally, three European economies. In addition, there is a general section on the policies of the European Community.

Each country study contains

- an outline of its trade and industry policy;
- a description of the specific export enhancement measures it uses; and
- comments on the effects of these policies on their own countries as well as on Australia.

I.1 Selecting the economies to examine

In selecting which economies to examine, the Commission placed greatest weight on a country's importance (or potential importance) as a trading partner or competitor for Australia. However, some countries were selected because of their importance to world trade. In 1989, the United States, Germany, Japan, France and the UK were (in that order) the world's five most important exporters of goods.

There is a major focus on economies in the Asia-Pacific region because of rising public interest within Australia in economic developments in this region.

The 13 economies selected include most of Australia's major sources of imports. In 1990, they accounted for 76 per cent of Australia's imports of goods, as shown in Table I.1. [1]

They also include Australia's most important export markets -- accounting for 72 per cent of our exports of goods in 1990. China was not selected despite it ranking tenth among our export markets and seventh as a source of imports. The exclusion of China was basically because of the difficulty in obtaining descriptive and analytical material.

Whilst the Commission's terms of reference refer to Australia's major trading partners, there is much of interest in our major competitors in overseas markets.

[1] Table I.1 does not take account of trade in services. In Australia’s case, services account for 20 per cent of all exports and about 25 per cent of al imports.

Table I. Intro 1: Australia's major trading partners: 1990

	Sources of imports		*Export markets*	
	Rank	*Share*	*Rank*	*Share*
		(%)		*(%)*
United States	1	23.8	2	11.3
Japan	2	18.8	1	26.2
United Kingdom	3	6.9	6	3.6
Germany FR	4	6.6	11	2.3
New Zealand	5	4.4	4	5.1
Taiwan	6	3.5	7	3.5
Italy	7	3.0	14	2.0
China	8	2.7	10	2.5
Korea [a]	9	2.4	3	5.9
Singapore	10	2.4	5	4.7
France	11	2.3	17	1.5
Hong Kong	14	1.6	9	2.6
Malaysia	16	1.3	15	1.9
Indonesia	19	1.1	8	2.6
Thailand	20	1.0	21	1.2
Total for 15 economies		**81.8**		**76.8**
EC nations		22.4		13.2
ASEAN nations [b]		6.1		11.3

a For convenience, the Republic of Korea is referred to throughout as Korea.
b The Association of South-East Asian Nations (ASEAN) comprises Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand.
Source: Department of Foreign Affairs and Trade 1991

In agricultural trade, the EC and the United States are Australia's most important competitors on export markets. However, there are several other important competitors in the market for specific commodities. New Zealand, for example, is Australia's most important competitor for wool exports (Table I.2).

Australia's competition for exports of mineral products is largely determined by the location of mineral deposits, with some countries being significant competitors for only a single commodity. BHP suggested that Brazil, India and South Africa would be worthy of study as major competitors on mineral and metallurgical export markets (Sub. 20). Resource constraints have not permitted such a complete study.

Table I.2: **Major commodity exporters: 1990-91** [a]
(Ranking and percentage share of world exports)

Rank	*Coal* [b]		*Aluminium*		*Iron Ore*	
		(%)		(%)		(%)
1	Australia	27	Canada	16	Brazil	28
2	United States	24	Australia	12	Australia	25
3	South Africa	12	United States	10	Soviet Union	10
4	Soviet Union	10	Norway	10	India	8
5	Canada	8	Brazil	8	Canada	7
6	Poland	7	Venezuela	5	South Africa	5
7	China	4	Netherlands	5	Sweden	4

Rank	*Wheat*		*Sugar*		*Beef and Veal*		*Wool*	
		(%)		(%)		(%)		(%)
1	United States	31	EC	23	Australia	30	Australia	57
2	EC	21	Cuba	22	EC	23	New Zealand	20
3	Canada	20	Thailand	15	United States	13	Uruguay	8
4	Australia	13	Australia	8	Argentina	12	Argentina	8
5	Argentina	6	Brazil	4	Uruguay	5	South Africa	7
6	Saudi Arabia	2	South Africa	3	Canada	3		

a Numbers in brackets indicate the country's percentage share of world exports.
b Coking coal and steaming coal.
Source: ABARE 1991

Australia is not a major exporter of manufactures, although exports from this sector are rising. International trade in manufactures is dominated by the United States, Germany and Japan. The export enhancement policies of these countries were therefore examined. The East Asian economies are also emerging as significant exporters of manufactures, and are increasingly setting new standards of international competitiveness. The policies in these countries which affect exports of manufactures were accordingly considered as well.

I.2 Trade performance of selected economies

The economies selected vary widely in their export orientation (Table I.3). For instance, Malaysia is ten times more export oriented than the United States -- the world's largest trader. However, there is no appropriate level of export orientation: it depends on the diversity of the country's industrial structure, its size, location and resource endowment. The United States' economy is far more diverse and over 100 times larger than that of Malaysia.

Table I.2: **Merchandise exports of selected economies**
(Per cent)

	Export growth 1980-89	*GDP growth 1980-89*	*Export orientation* [a]	
			1979	*1989*
Australia	**4.1**	**3.5**	**14.5**	**11.8**
Hong Kong [b]	12.3	7.1	87.2	117.0
Indonesia	2.4	5.3	31.7	23.2
Japan	4.6	4.0	10.6	9.8
Korea	13.8	9.7	24.8	29.4
Malaysia	9.8	4.9	54.5	66.8
Singapore	8.1	6.1	158.0	157.3
Taiwan [c]	13.5	8.0	48.8	50.0
Thailand	12.8	7.0	19.1	28.8
New Zealand	3.5	2.2	25.6	20.8
United States	2.3	3.3	7.6	6.7
France	3.3	2.1	17.2	18.1
Germany FR	4.4	1.9	22.5	28.7
United Kingdom	2.7	2.6	22.7	21.2

a Exports as a share of GDP.
b Export growth for 1980-88 and export orientation in 1988.
c Growth rates for Taiwan are for 1980-87.
Sources: CEPD 1990; GATT 1990; World Bank 1991

These measures, though, are useful to see if a nation is becoming more export oriented. There have been some spectacular increases in export orientation during the 1980s (Table I.3), especially for the Asian countries. Export growth has greatly exceeded output growth in many of these economies. For instance, Taiwan achieved an average annual export growth of 13.5 per cent compared with 8.0 per cent GDP growth; Korea had 13.8 per cent export growth compared with GDP growth of 9.7 per cent. Thailand's export growth also greatly exceeded GDP growth, so much so that export orientation increased from 19.1 per cent in 1979 to 28.8 per cent in 1989.

There are no similar dramatic changes among the more developed economies, such as Germany, the United Kingdom and the United States. In Australia's case, export orientation declined, despite export growth exceeding GDP growth over this period. This was due to a surge in import growth.

The stronger export performance of the East Asian economies has resulted in them becoming a much larger force in world trade. Between the mid-1970s and the late 1980s, many of these countries substantially increased their ranking among the world's exporters in both services and merchandise trade (Table I.4).

Table I.4: **Ranking of exporters in world trade**

	Merchandise		*Services*	
	1973	*1989*	*1975*	*1989*
United States	1	1	1	1
Germany FR	2	2	4	4
Japan	3	3	7	5
France	4	4	2	2
United Kingdom	5	5	3	3
Hong Kong	25	11	31	13
Taiwan	28	12	26	21
Korea	39	13	30	15
Singapore	33	17	17	16
Australia	**12**	**19**	**18**	**20**
Malaysia	41	27	47	34
Indonesia	40	31	na	40+
Thailand	51	33	43	22
New Zealand	na	40+	29	38

na not available.
Source: GATT 1990, vol. 2, p.3

I.3 Stage of economic development

The Commission has sought to select a range of economies at different stages of development. A number of East Asian economies warrant inclusion because of their very fast growth in recent years -- in both GDP and exports -- and/or because they are often cited as successful examples of the use of export enhancement measures which Australia could usefully copy.

The size of the selected economies varies enormously. The United States' economy is over 25 times that of Australia's, whilst Singapore's economy is only one seventh that of Australia's.

Some of the world's highest-income economies -- as well as several with very much lower incomes -- are included. From Table I.5 it can be seen the sample ranges from annual GNP per head of $A421 in Indonesia to almost $A19 000 in Japan (in 1989).[2]

While *per capita* income levels in many of the industrialised economies have been growing at around 2 per cent a year, average per capita income growth for developing countries as a whole has been higher. However, the fastest growth has been among economies in the Asia-Pacific region. In Singapore, Taiwan and Korea, per capita income increased at an average annual rate of 7 per cent between 1965 and 1989.

2 $A estimates used in this report are expressed in terms of 1990 Australian prices.

Table I.5: **Some basic income indicators for the selected economies**
(Per cent)

	GNP in 1989	*Population*	*GNP per head in 1989*	*GNP per head real annual growth 1965-89*
	($Ab)	*(millions)*	*($A)*	*(%)*
Australia	**195**	**16.8**	**11 607**	**1.7**
Hong Kong	50	5.7	8 772	6.3
Indonesia	75	178.2	421	4.4
Japan	2 334	123.1	18 960	4.3
Korea	159	42.4	3 750	7.0
Malaysia	31	17.4	1 782	4.0
Singapore	23	2.7	8 519	7.0
Taiwan	115	20.1	5 721	7.2
Thailand	56	55.4	1 011	4.2
New Zealand	33	3.3	10 000	0.8
United States	4 402	248.8	17 693	1.6
France	798	56.2	14 199	2.3
Germany FR	1 025	62.0	16 532	2.4
United Kingdom	693	57.2	12 115	2.0

Note: GDP data are used for Hong Kong.
Source: CEPD 1990; World Bank 1991, pp. 204-5

Changing structures of production

In all of the economies selected for which data are available, agriculture's share of national production has shrunk in importance (Table I.6). This is the case especially in the developing economies, but has also been an important feature of development in Australia and Japan. In OECD countries and Hong Kong, there has been a fall in the importance of the industrial sector, with compensating growth in the service sector. While there has also been growth in services in the developing economies, this has generally been outstripped by growth in their industrial sectors as these economies industrialise.

Table I.6: **Distribution of GDP: 1965 and 1989**
(Per cent)

	Agriculture		*Industry*				*Services*	
			Total		*Manufacturing*			
	1965	*1989*	*1965*	*1989*	*1965*	*1989*	*1965*	*1989*
Australia	**9**	4	**39**	32	**26**	15	**51**	64
Hong Kong	2	0	40	28	24	21	58	72
Indonesia	56	23	13	37	8	17	31	39
Japan	10	3	44	41	34	30	46	56
Korea	38	10	25	44	18	26	37	36
Malaysia	28	..	25	..	9	..	47	..
Singapore	3	0	24	37	15	26	74	63
Taiwan	24	5	30	48	22	40	46	47
Thailand	32	15	23	38	14	21	45	47
New Zealand	..	8	..	28	..	17	..	64
United States	3	2	38	29	28	17	59	69
France	..	3	..	29	..	21	..	67
Germany FR	4	2	53	37	40	32	43	62
United Kingdom	3	2	46	37	34	20	51	62

Notes: .. not available.
Because manufacturing is generally the most dynamic part of the industrial sector, its share of GDP is shown separately.
Figures in italics are for other years
Data for Taiwan are for 1965 and 1987

Source: World Bank 1991, pp. 208-9; CEPD 1990, p.330.

These changes in output are mirrored in the composition of exports as shown in Table I.7. In each of the economies, except perhaps Germany, exports of primary products have become less important. This change is most dramatic in the developing economies, each of which has greatly expanded its exports of manufactures.

While the EC countries, the United States and Japan put a lot of effort into protecting their agricultural sectors, it is interesting to see from Table I.6 that agriculture in France, Germany, Japan, the UK and the United States in each case provides at most 3 per cent of GDP. From Table I.7, however, it can be seen that this sector is a much more important as a source of exports, being 16 per cent for the United States, 8 per cent for the UK and 18 per cent for France.

Table I.7: **Structure of merchandise exports: 1965 and 1989**
(Per cent)

	Fuels, minerals metals		*Other primary products*		*Machines, transport equipment*		*Other manufactures*	
	1965	*1989*	*1965*	*1989*	*1965*	*1989*	*1965*	*1989*
Australia	**13**	**32**	**73**	**35**	**5**	**5**	**10**	**27**
Hong Kong	1	1	5	2	7	23	87	73
Indonesia	43	47	53	21	3	1	1	31
Japan	2	1	7	1	31	65	60	32
Korea	15	2	25	5	3	38	56	55
Malaysia	34	19	60	37	2	27	4	17
Singapore	21	18	44	9	10	47	24	26
Taiwan	2	1	56	6	4	30	37	63
Thailand	11	3	86	43	0	15	3	39
New Zealand	1	9	94	67	0	5	5	19
United States	8	6	27	16	37	43	28	34
France	8	5	21	18	26	35	45	21
Germany FR	7	4	5	6	46	49	42	41
United Kingdom	7	10	9	8	42	40	42	40

Note: Figures in italics are for other years.
Data for Taiwan are for 1965 and 1987; the World Bank does not publish data for Taiwan.

Source: CEPD 1990, p. 342; World Bank 1991, pp. 234-5

I.4 Prevalence of export enhancement measures

Table I.8 summarises the Commission's assessment of the use of a range of export enhancement measures in the 13 economies. There is a considerable degree of judgement involved in the conclusions shown in this table and it must be read in conjunction with the detailed text. The tentative nature of the table reflects the paucity of studies which might be trusted to provide a rigorous analysis of policies and their effects. There are many studies which examine the effects of a policy on one sector of an economy, many also which look at the effects of such policies on third (especially developing) economies, but few which attempt an economy-wide analysis.

The Commission has endeavoured to use the most up-to-date information, but almost certainly there will have been changes. However, there is a good deal of historical data as well and this has been used in assessing the impact of export enhancement measures. The emphasis for most countries has been on measures which enhance exports of goods; there do not appear to be many measures aimed specifically at increasing exports of services, although there are many barriers to their trade.

Table I.8: **A broad summary of the current use of export enhancement measures in selected economies [a,b]**

Economy	*Direct Subsidies* [c]	*Finance*	*Tax incentives* [d]	*EPZ*	*Marketing structure*	*Infra-*	*TRIMs*	*R&D*
Australia	**S**	**G**	x	x	**G**	s	s	**G**
Hong Kong	x	g	x [e]	x [f]	**G**	s	x	g
Indonesia	x	**G**	x	s	**G**	**S**	x	x
Japan	x	**G**	x	x	g	x	x	g
Republic of Korea	x	**G**	**G**	g	**G**	**G**	s	**S**
Malaysia	x	**G**	**G**	**G**	**G**	**G**	**G**	**G**
Singapore	x	g	**G**	**G** [f]	**G**	**G**	**G**	**G**
Taiwan	x	**G**	**G**	**S**	g	**G**	**S**	S
Thailand	x	g	s	**S**	**G**	**S**	**S**	x
New Zealand	x	x	x	x	**G**	x	x	x
United States	**S** *	**G**	g	x	**G**	x	x	**S**
France	**S** *	**G**	x	x	**G**	**G**	s	**S**
Germany FR	**S** *	**G**	x	x	g	x	x	**S**
United Kingdom	**S** *	**G**	x	x	**G**	x	x	**S**

a This table applies to central, and not state or local, government export enhancement measures.
b *Key* x This type of enhancement measure is not used so far as the Commission understands.
G/g Assistance through this measure is generally available.
S/s Assistance through this measure is selective.
Bold upper-case lettering indicates government expenditure (or indirect measures) which involve relatively large amounts of resources.
c Includes direct subsidies to exports and general grants, bounties, export facilitation schemes and other countervailable subsidies. Excluded are tax incentives which are treated in the third column of this table.
d Excludes value-added tax (VAT) refunds and import duty exemptions and drawbacks.
e Hong Kong's general tax regime is lower than most other economies studied.
f It can be argued that the whole economy is an EPZ.
• Includes substantial agricultural export subsidies.

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II HONG KONG

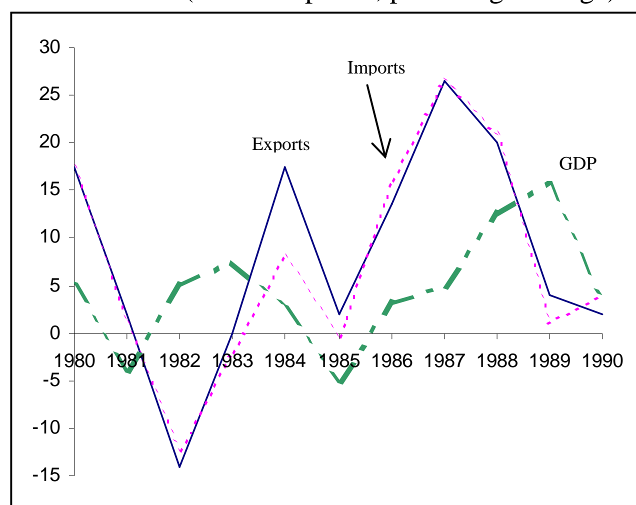
The Hong Kong economy is heavily concentrated in the services and manufacturing sectors, though the proportion of manufacturing employment has fallen from 46 per cent of total employment in 1980 to 30 per cent in 1990. One of the main reasons for this is the shift of labour-intensive processes across the border into southern China. In 1980, Hong Kong's manufacturers operated almost entirely in Hong Kong. Now nearly three million Chinese work in Hong Kong-owned companies in southern China's Shenzen Special Economic Zone and Guangdong Province. This is more than double the number of persons engaged in manufacturing in Hong Kong.

Hong Kong has become an integral part of the `Greater China' economy which is reflected in the trade and investment flows between China, Hong Kong and Taiwan and between these economies and the rest of the world.

II.1 Trade performance

Hong Kong is among the world's top eleven trading economies. In 1990, Hong Kong's exports (including re-exports) amounted to $HK640 billion ($A105b)[1] -- over 115 per cent of GDP. Imports were also $HK640 billion -- about one-third of which was retained, the remainder being re-exported. Hong Kong's exports, re-exports and imports increased rapidly over the decade to 1990, at average annual rates of 15, 33 and 21 per cent respectively (Figure II.1). Some 90 per cent of Hong Kong's manufactured products are for export.

Figure II.1: **Hong Kong's growth in GDP and merchandise trade: 1980-90**
(Constant prices, percentage change)



Sources: IMF 1991; World Bank 1991

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

Re-exports account for a greater proportion of total exports than domestically produced goods: 65 per cent in 1990. The main sources of these re-exports are China, Japan, Taiwan, the United States and the Republic of Korea. The largest markets for Hong Kong's re-exports are China, the United States, Japan, Germany, and Taiwan (Roberts 1990).

Hong Kong's merchandise exports are mainly clothing, textiles, office machinery, telecommunications and other consumer goods (Table II.1).

Table II.1: **Merchandise exports from Hong Kong: 1979 and 1989** [a]
(Per cent)

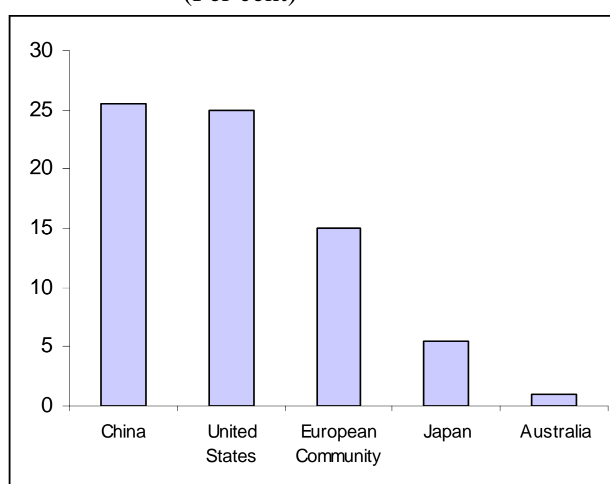
Commodity	*1979*	*1989*
	%	*%*
Clothing	28	19
Office machinery and telecommunications	12	15
Textiles	9	10
Other consumer goods	27	24
Other semi-manufactures	7	6
Electric machinery and apparatus	3	6
Other non-electric machinery	1	4
Chemicals	4	5
Food	3	4
Raw materials	2	2
Other	4	5

a Data are for total exports including re-exports.
Source: GATT 1990

Hong Kong: A Window to China

China is Hong Kong's major trading partner, accounting for over 25 per cent of total exports (Figure II.2). The major industrial nations (USA, Japan, EC) account for most of the remainder of Hong Kong's exports, while the growing ASEAN markets do not yet comprise a substantial share.

Figure II.2: **Major destinations of Hong Kong's export: 1989**
(Per cent)



Source: GATT 1990

Hong Kong has become the major port of entry and exit for Chinese imports and exports. By 1989, re-exports from China through Hong Kong were the largest element in Hong Kong's re-export trade, with the United States being the largest single market The growth of re-exports, and hence of the entrepôt function of Hong Kong, represents a confirmation of Hong Kong's historical trading role -- having advantages of a safe deepwater port, easy access to the south China region, and being well placed in terms of international trade routes.

As a trading economy, Hong Kong is sensitive to changes in its external economic environment, particularly the economic `health' of its main trading partners, including China. For example, lower world economic growth -- together with civil disturbances (and the subsequent international reaction) and economic policy changes in China -- adversely affected Hong Kong in the late 1980s.

II.2 Trade and industry policy

The Government's *laissez-faire* policies, which provided a benign environment to refugee business and capital which decamped after the 1949 revolution in China, can be described as the economy's main export strategy. Before that, Hong Kong was established as an entrepôt for exports from China. The port was the key to economic activity. A policy to maintain and upgrade the port and associated infrastructure and to facilitate its modernisation is possibly the second most important strategy pursued by the administration to support exports.

According to the Government:

> Hong Kong advocates and practices free trade. [The] import and export system is characterised by minimum controls, zero tariff and no subsidies or assistance to exports (GATT 1990, p. vii).

Further, the Government does not maintain any quotas, surcharges, safeguards, anti-dumping or countervailing actions, concessional export credit, export taxes or Government-mandated countertrade. Nor does the Government operate any state trading enterprises or impose any foreign exchange controls. (What import and export controls do exist either stem from obligations under international undertakings, or are applied for health, safety or security reasons.)

The Government regards its *laissez-faire* economic policy and low tax rates on corporations (16.5 per cent) and individuals (up to 15 per cent) as providing sufficient incentive for foreign funds to enter the economy. There are no specific incentives offered to new investors -- other than some relatively favourable rental policies available in industrial estates. One of the greatest attractions of Hong Kong for many foreign investors is the absence of any restriction on enterprise ownership.

The Government takes the view that, unless there are sound social or economic reasons suggesting otherwise, it does not normally interfere in the operation of the economy, particularly the activities

of the private sector. Its role in the economic development process is one of facilitation. It seeks to ensure a socioeconomic environment which is conducive to economic growth and development. Pragmatism, adaptability and resilience, coupled with a strong sense of business enterprise and hard work, are key ingredients of the development of Hong Kong's economy (GATT 1990, p. viii).

The Hong Kong Government describes its industrial policy as `positive non-interventionism'. In describing Hong Kong's industry policy, the Government's Director of Industry noted:

> ... the substantial investment which the Hong Kong government has made in order to create the generally favourable investment environment in Hong Kong: maintaining law and order; setting a low tax rate; running a free trade policy; providing land; providing a decent transport infrastructure; providing education and training manpower; and encouraging overseas investment in Hong Kong ... [And the removal, where possible, of] infrastructural and technological constraints on the development of Hong Kong's manufacturing industries, and to maintain the freest possible market in industrial resources and the freest possible trading environment (Barma 1991a, p.2-3).

Industrial policy in Hong Kong has always avoided providing subsidies for `fashionable' industries and safety nets for poorly performing companies.

> The Industry Department does not spend its time `picking winners'. We do not spend our time devising ingenious subsidies to stimulate the growth of `strategic' industries. We do not spend our time crystal-ball gazing, and trying to create exotic new industries in Hong Kong from nothing, just to show that we can do so. We start from the premise that businessmen normally know what they are doing, and that civil servants should keep out of their way as much as possible (Barma 1991b, p.4).

II.3 Export enhancement measures

The Hong Kong Government maintains export marketing and export credit insurance agencies which provide some assistance to exports. In addition, several public programs boost the general level of industrial activity and indirectly increase exports -- given the economy's outward trade orientation. While there are no export processing zones (EPZs) in Hong Kong, from an economic standpoint it is reasonable to describe the entire economy as an EPZ.

Export marketing assistance

Established in 1966, the Hong Kong Trade Development Council (TDC) is a statutory organisation responsible for expanding the markets for Hong Kong's manufactured goods, promoting Hong Kong's products, and creating a favourable image of Hong Kong as a trading partner and manufacturing centre. The Council makes recommendations to the Government on measures it believes would increase Hong Kong's trade.

To keep overseas business concerns informed of the opportunities Hong Kong offers, the Council maintains 33 offices in 23 countries, and it uses agents elsewhere. Through its overseas branches, the Council implements a world-wide program of trade promotion. It does this through participation in activities such as trade fairs, seminars and publications. The Council also maintains a computerised trade enquiry database which lists local manufacturers, exporters, and importers.

Activities are largely funded through a small levy (0.05 per cent) on imports and exports. In fiscal year 1990-91, the levy raised $HK395 million ($A65m). Expenditure that year was over $HK569 million ($A93m), the difference coming from income generated from operational activities such as trade fairs and publications.

Export finance assistance

The Hong Kong Export Credit Insurance Corporation (ECIC) was established in 1966 to provide guarantees for exporters against the otherwise uninsurable risks of non-payment for goods and services exported on credit terms. The services provided by the Corporation are fairly standard and fall into three main categories: insurance, credit advice, and risk-management advice. It does not provide credit. ECIC has been a full member of the Berne Union since 1968 (see Volume 1, Appendix D).

ECIC insured $HK12 billion ($A2b) worth of business in 1989-90 (ECIC 1990). By 1991, total insured business had accumulated to $HK98 billion ($A16b) (Jacobs 1991).

The Corporation has had to pay its way in a commercial manner, without recurrent government funding, and it markets its services like any private company. ECIC's paid-up capital was provided by the Government, which also guarantees the payment of all monies due by the Corporation.

ECIC is a minor part of Hong Kong's trade environment. It had 1849 policies in force on 31 March 1990, 92 per cent being comprehensive shipment policies. This represents approximately 2 per cent of Hong Kong's total merchandise exports (including re-exports).

According to its accounts, the Corporation achieved a surplus of $HK29 million ($A4.8m) in 1989-90. ECIC's capital, however, came from the Government. This capital can be regarded, at least notionally, as being invested in Government bonds or notes. Such investments should generate a steady stream of income to the Government. If ECIC's annual operating surplus is less than these notional receipts, the agency is not paying its way even though its balance sheet is in surplus.

In fact, ECIC suffered cumulative underwriting losses over 1975-85, although investment income from its capital, plus undistributed surpluses, allowed it to show an accounting surplus that averaged 5.8 per cent of assets. According to Fitzgerald and Monson (1989), these underwriting losses plus forgone income on accumulated losses represented a small subsidy from ECIC -- 0.13 per cent of the value of insured exports.

Tax incentives and concessions

Offshore income is not subject to tax in Hong Kong. Income and business tax rates are very low. In addition, depreciation rates on capital goods of 85-90 per cent are allowed within three years, with 55 per cent allowed in the first year.

Infrastructure

The majority of factories in Hong Kong are accommodated in multi-storey buildings. For industrial processes which are land and capital intensive, the Hong Kong Industrial Estates Corporation (IEC) provides sites on industrial estates. The Corporation manages two industrial estates, in Tai Po and Yuen Long, and is developing a third in Tseung Kwan O through land reclamation. Sites on the third estate are scheduled to be available in 1993.

All three industrial estates are located near cities with populations of up to 400 000, giving companies a ready supply of employees. They also have good transport links to the urban area, container terminal, airport, and the border with China.

Land prices in the estates are based on cost and are fully serviced with roads, electricity, and water. According to its accounts, IEC is operated on a full-cost-recovery basis. However, an implicit subsidy exists through the availability of concessional finance from the Government. For example, the estimated cost of developing the Tseung Kwan O estate is a little over $HK1 billion ($A164m). To cover this, a loan facility of $HK900 million ($A148m) has been arranged through IEC's Loan Fund. This facility is to be repaid at a rate of 5 per cent per annum (IEC 1990). The provision of loans at below market interest rates reduces the costs of IEC, and thus the provision of facilities, even on a full-cost-recovery basis, provides an indirect subsidy to companies.
Research and development

An applied R&D scheme is to be introduced in 1992. Under the scheme, the Government will provide about $HK200 million ($A32m) to companies in the form of an investment in R&D projects. The object is to encourage a higher level of private sector investment in applied R&D. The Government plans to allocate about $HK400 million ($A65m) over the next three years to improve the R&D capabilities of Hong Kong's universities and colleges.

Other measures

The Hong Kong Productivity Council (HKPC) was established in 1967 to promote increased industrial productivity. It is financed by an annual Government allocation and by fees earned from its services. HKPC provides a variety of training programs, industrial and management consultancies, and technical support services. Its facilities include two training centres; electronic data processing facilities; laboratories for microprocessor applications, industrial chemistry, metal finishing, heat treatment, die casting and environmental control; a computer-aided design centre and computer-aided manufacturing workshop; a technical reference library; and an on-line information retrieval service.

The Council also undertakes consultancy projects for local and foreign companies in areas as diverse as feasibility studies, production management, new plant, personnel recruitment, marketing and technical assistance.

II.4 Effects of export enhancement measures

The virtual absence of direct export enhancement measures indicates that such measures are not necessary to attract investment to Hong Kong. An Industry Department survey of 584 companies in September 1990 showed what factors are important to firms making decisions whether or not to locate in Hong Kong (Table II.2).

It is worth adding that Hong Kong would be advantaged to the extent that Chinese subsidies flow on from goods produced there and re-exported through Hong Kong. Estimating any benefit, though, is extremely difficult.

As it does not subsidise exports or provide protection against imports, Hong Kong's trade policy has no negative impact on Australia. There

Table II.2: **Importance of investment factors to corporate location decisions: 1990 [a]**

Investment factor	*Ranking*
Political stability	1
Political future	2
Banking and financial facilities	3
Infrastructure	4
Labour cost	5
Labour productivity	6
Government economic policy	7
Cost of factory space	8
Availability of technical skill	9
Availability of managerial skill	10
Business laws and regulations	11
Corporate taxes	12
Labour-management relationship	13
Pegging of $HK to $US	14
Regional location	15
Exchange controls	16
Gateway to China	17
Supporting industries	18
Government bureaucracy	19
Labour market potential	20

a Survey of 584 companies.
Source: Industry Department 1990b

is also no positive impact, that is, by not transferring taxes overseas in the form of under-priced exports, Hong Kong's citizens do not subsidise Australia's imports.

II.5 Concluding comments

Hong Kong's achievements have come about under a trade regime with no tariffs, no quotas, no direct subsidies, no export credit assistance and only limited official export insurance and marketing facilities.

The contribution of Government policy to Hong Kong's growth has been to maintain an environment in which business could be profitable. It has fostered a low-tax environment and has consciously avoided adding to labour costs. The entire economy can be described as an export processing zone: goods are imported duty free and processed by plant which operates with low wage costs and minimal tax impositions. The goods are then (re-) exported. A deliberate policy to maintain the port and facilitate its modernisation is possibly the second most important strategy pursued by the administration to support and facilitate exports.

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III INDONESIA

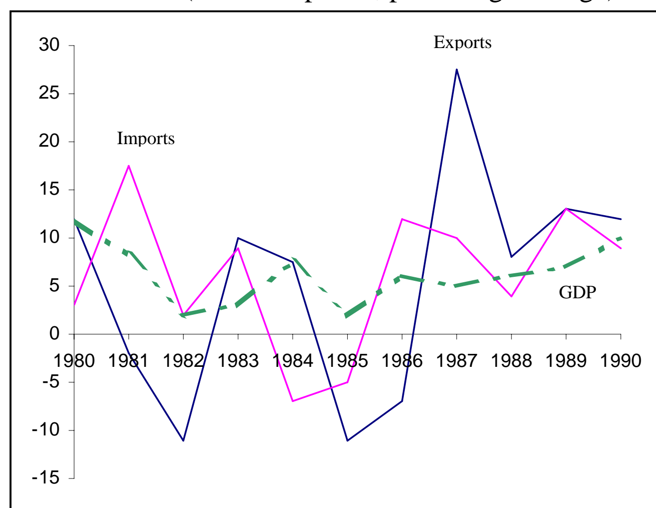
Indonesia is the fifth most populous country in the world, the third largest developing country and the largest economy in ASEAN. Average annual economic growth since 1985, as measured by movements in real GDP, has exceeded 5 per cent.

Indonesia is rich in natural resources. It is the world's largest producer of certain spices, the second largest producer of natural rubber and palm oil, the third largest producer of coffee and a leading producer of copra. It is also the world's major producer of tropical hardwoods. Finally, Indonesia has considerable reserves of oil and natural gas, as well as a variety of mineral resources -- including tin, nickel, coal, copper, bauxite and some precious metals.

III.1 Trade performance

Indonesia's export performance since the 1960s can be characterised by three distinct periods. Before 1971, agricultural commodities dominated Indonesian exports, accounting for more than half of total exports. The oil price shocks of the 1970s had a dramatic effect on Indonesia's export earnings. The value of oil exports rose by 300 per cent in response to the first shock in 1973, and by a further 75 per cent as a result of the second shock in 1979. Oil dominated Indonesia's export earnings during this period, reaching a high of 85 per cent in 1982.

Figure III.1: **Indonesia's growth in GDP and trade: 1980-90 a**
(Constant prices, percentage change)



Source: IMF 1991

Between 1981 and 1986, falling commodity prices (especially for petroleum) depressed Indonesia's trade performance. However, Indonesia's trade performance turned around following a major policy shift in the early 1980s. This was aimed at reducing the country's dependence on oil and primary commodity exports, by encouraging the development of manufactured exports.

The average annual growth in merchandise exports over the 1980s was about 10 per cent. Labour- and resource-intensive manufactures became important export items during the 1980s. Indonesian labour costs are lower than many of its Asian competitors (such as Korea, Malaysia, and Taiwan), but not as low as those of China.

The share of manufactured exports in total exports grew from 2 per cent in 1980 to 33 per cent in 1989, and that of mining exports (which includes oil and gas) declined from 76 per cent in 1980 to 46 per cent in 1989 (Table III.1).

Export diversification has been strongest in processed natural-resource-based products such as plywood (the single most important manufactured export item), and major labour-intensive industries like clothing and footwear. Several smaller industries such as rattan furniture, petrochemicals, and pulp and paper have emerged as potentially important economic activities. Agricultural exports have also performed well.

Table III.2: **Merchandise exports from Indonesia: 1980 and 1989**
(Per cent)

Industry	*1980*	*1989*
Agriculture	**22**	**21**
Rubber	5	5
Coffee	3	2
Vegetable oil	1	2
Wood, shaped	1	4
Fish	1	3
Other	11	5
Manufactures [a]	**2**	**33**
Veneers, plywood	..	14
Clothing and textiles	..	7
Other	2	12
Mining and other	**76**	**46**
Crude petroleum and gas	53	36
Petroleum products	5	4
Nonferrous base metal ore	2	3
Aluminium	1	2
Tin	2	1
Other	13	..
Total	**100**	**100**

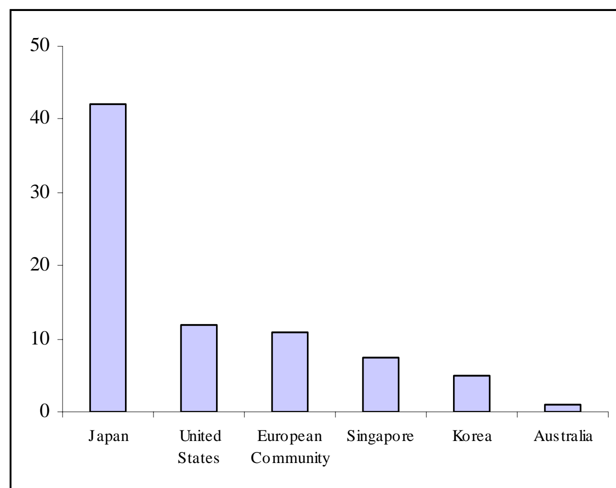
a Industry shares within the manufacturing sector are based on 1987 data.
Source: APEG 1991

While the growth in manufactured exports has been rapid, the range of products involved remains relatively narrow. The three major manufactured exports during the 1980s were plywood, clothing and textiles. These three product categories contribute 70 per cent of total value of manufactured exports. An important influence on the growth of plywood exports was the log export ban. A number of other manufactures have recently begun to increase in importance. For example, annual exports of footwear increased from $A15 million in 1986 to $A54 million by July 1988.[1]

[1] $A estimates used in this report are expressed in terms of 1990 Australia prices.

Geographical diversification of trade has been less pronounced. Japan, the United States and Singapore remain Indonesia's main trading partners, accounting for over half of merchandise trade (Figure III.2). Buoyant growth has occurred in trade with other ASEAN members, the major developing economies of East Asia and the European Community.

Figure III.2: **Major destinations of Indonesia's exports: 1990**
(Per cent)



Source: Australian Department of Foreign Affairs and Trade

III.2 Trade and industry policy

Until the mid-1980s, Indonesian trade and industry policy was `inward looking', that is, focussed on import substitution underpinned by high import barriers. Since then, liberalisation and reform measures have resulted in a more open economy.

Indonesia's import substitution phase commenced in the 1960s. Import bans and domestic content quotas were introduced. These initially concentrated on consumer goods, but were later extended to include intermediate and capital goods. These tariff and non-tariff barriers were used to effectively insulate domestic industry from international competition.

During the oil-boom years of the 1970s, trade policy became particularly restrictive, as self sufficiency was sought in a range of targeted industries. A `deletion' program was introduced which set out a timetable for achieving pre-specified levels of domestic content in a selection of product areas. The list of sectors closed to foreign investment was also expanded at this time. Additionally, the small amount of foreign direct investment that was permitted was required to take the form of joint ventures with local partners.

These policies imposed substantial costs on the economy. High tariffs and additional administrative costs for importers increased production costs for many industries. As a result, the international competitiveness of much of Indonesian industry was reduced.

With Indonesia targeting particular industries for special assistance, effective rates of protection varied enormously across industries. Some industries were penalised by assistance provided to others, while others were assisted at rates of more than 100 per cent. Many labour-intensive industries (and other industries with export potential) suffered because of these policies.

The dependence of the Indonesian economy on oil and gas for export revenue was very marked during this period, accounting for more than three quarters of Indonesia's export earnings in 1981-82. Consequently, the decline in oil prices which began during 1982 had serious repercussions. GDP growth fell from an annual average of 7.5 per cent in the period 1973-81 to just 3 per cent between 1981 and 1986. External debt, a third of which was denominated in (strongly appreciating) yen, rose almost 250 per cent during this period. Government revenue -- 60 per cent of which was sourced from taxes on oil companies -- fell considerably.

These setbacks led to a major review of trade and industry policy. Inefficiencies attributable to Indonesia's system of manufacturing protection could no longer be afforded. Accordingly, a liberalisation program was implemented from 1983, involving measures designed to make Indonesian industry more internationally competitive, as well as to encourage non-oil exports to compensate for the loss of oil revenues.

After experimenting with a system of direct export subsidies in 1983, a compensation-oriented system (BAPEKSTA) was introduced in 1986. Exporters were offered duty drawbacks and exemptions on imported inputs used in exports. Importantly, the administration of this program was efficient and effective, to the point where it was accessible to most Indonesian exporters by the middle of 1987. According to the World Bank (1991), the BAPEKSTA facility has worked extremely well, expanding rapidly to cover about 24 per cent of total manufactured non-oil exports by 1988. The Bank also noted that BAPEKSTA is important because it ensures access to good quality and uniform inputs and because it increases competitive pressures on potential domestic input suppliers.

Another frequently cited measure used to assist exports was the reform of the customs service in 1985. The Government transferred the responsibility for customs surveillance to a private Swiss company (SGS) in order to counter the exiting system's notorious inefficiencies. An array of administrative requirements had resulted in long delays for both importers and exporters using the system, with the result that the costs of processing goods through Indonesian ports had raised the costs of engaging in international trade to unacceptable levels. This initiative was important, because it demonstrated the Government's resolve to tackle vested interests and corruption which were pervasive in other areas of public administration.

Between 1986 and 1988, Indonesia's extensive system of protection was progressively liberalised. Non-tariff barriers, such as quotas, were converted to equivalent tariffs. As a result of these

initiatives, the proportion of manufacturing output protected by non-tariff restrictions fell from nearly 50 per cent in 1986 to around 30 per cent in 1988. Accompanying this rationalisation of non-tariff barriers was a comprehensive tariff reform that was initiated in 1986. The maximum tariff rate was reduced from 225 per cent to 60 per cent, with most tariffs falling in the range 5-35 per cent. The average tariff rate was reduced to 10 per cent, which was less than half the level in the early 1980s (22 per cent).

Indonesia's more open economy quickly attracted additional foreign investment. Between 1986 and 1987, there was a dramatic increase in export-oriented investment approvals -- with planned exports of $A26 billion. Of the 1329 domestic investment projects which were approved in 1990, 937 intended to export, as did 311 of the 432 joint ventures involving foreign direct investment.

Investment approvals recorded by the National Investment Co-ordinating Board (Badan Kordinasi Penanaman Modal or BKPM) show manufacturing industry to be the most popular activity for private investors, both domestic and foreign. Approximately two thirds (by number) of new domestic investment projects and almost three quarters of foreign investment projects approved in 1990 were in manufacturing activities, chiefly in the chemicals and textiles industries. Japan remains by far the most important country of origin of foreign direct investment into Indonesia, accounting for no less than A$2.8 billion of the total sum of A$11.1 billion committed in 1990. The other principal sources of foreign investment funds in 1990 were Hong Kong, Korea and Taiwan (EIU 1991).

Investment plans for which approvals have been obtained have not always been realised. According to the World Bank (1991), this is partly due to remaining complexities and weaknesses of the domestic regulatory framework. The Bank went on to observe that it is also not certain that all this new investment is being channelled into areas where Indonesia has a clear comparative advantage partly due to remaining distortions in the trade regime.

While these reforms have had considerable impact on the economy, a range of restrictions on trade still apply. In fact, import prohibitions and restrictions continue to affect more than a quarter of tradeable goods, including three quarters of mineral products. For example, import bans apply to completely built-up motorbikes, passenger vehicles, trucks, as well as to printed matter and agricultural machinery. Most of these bans exist to protect domestic manufacturing or assembly operations, although other reasons have been advanced -- such as national security or the protection of Indonesian culture. (GATT 1991, p.63) There are also export bans, for example, on unprocessed primary commodities, aimed at encouraging more value-adding to be undertaken domestically.

There are other problems. Like other emerging economies in the region, Indonesian growth has tended to overwhelm available infrastructure, creating a severe bottleneck to the efficient movement of goods into, around and out of the country.

III.3 Export enhancement measures

Indonesia signed the GATT Subsidies Code in 1985, undertaking to phase out export subsidies by April 1990. Consequently, Indonesia employs only some of the export enhancement measures discussed in this report.

Export marketing assistance

The National Agency for Export Development and the Export Support Board (ESB) are both concerned with export market development assistance. The first agency provides assistance in overseas marketing and promotion, while ESB is primarily an advisory body.

Promotional activities include the provision of marketing information, participation in and organisation of trade fairs, and activities undertaken by overseas trade representatives. The ESB reimburses approved costs of export campaigns on a cost-sharing basis (up to 75 per cent of project costs).

Export finance

Subsidised short-term export financing, pre-shipment export finance guarantees, and export credit insurance/guarantees were introduced in 1982, under the Export Credit Facilitation Scheme (ECFS). Initially this program allowed only state-owned banks to participate in the provision of export credit. This restriction was removed in 1985, and now almost all banks are involved in export finance. State banks still dominate the market by virtue of their sheer size, although their share of total export credits outstanding has declined from over 90 per cent in 1985 to 75 per cent in 1989 (World Bank 1991).

In its first years of operation, the ECFS provided credit to exporters at subsidised rates. This was particularly important for exporters competing on world markets because of the high interest rates prevailing in Indonesia during the 1980s. Between 1984 and 1988, prime lending rates averaged 24 per cent, the highest in ASEAN. Export credit was made available for as low as 6 per cent during this period.

The ECFS was progressively phased out following Indonesia's accession to the GATT Subsidies Code. Since the scheme's demise, export credit rates have been in line with market rates. However, export finance is still treated as a priority area within the banking system. Two mechanisms are employed to ensure that this is the case(Simandjuntak 1990).

First, the central bank (Bank Indonesia) provides liquidity at a uniform rate of 3 per cent to lending banks for the refinancing of export credits. This is lower than the rate available for other forms of credit, and has been occasionally lower than bank deposit rates. The availability of this facility varies for different types of export product. Agricultural products can be refinanced up to 70 per cent of the value of exports, while the limit for non-agricultural products is 50 per cent (ADB 1990).

Second, all joint venture and foreign banks operating in Indonesia must maintain a minimum of 50 per cent of their outstanding credits as export credits within 12 months of obtaining their banking licence. This provision promotes the extension of export credit to riskier projects than would otherwise be the case.

Export credit guarantees are compulsory for all export loans. The government-owned Asuransi Elespor Indonesia (PT ASEI) is responsible for the provision of this service. The insurance fee is paid by PT ASEI, which is reimbursed 50 per cent of this amount by Bank Indonesia. Up to 85 per cent of the loan outstanding is guaranteed against insolvency or default by the exporter.

Export credit insurance is optional for exporters. PT ASEI provides insurance on a discretionary basis, reserving the right to refuse cover due to such contingencies as excessive political risk. As with credit guarantees, export insurance provides cover for up to 85 per cent of export value.

As a result of its voluntary nature and recent introduction, export credit insurance is not widely used in Indonesia. In part, this may also be due to the conservative marketing approach employed by PT ASEI and its, as yet, relatively unsophisticated product range.

In addition to the general insurance schemes mentioned above, the Government funds the Export Credit Insurance Guarantee Scheme. This covers exporters against non-payment on the part of foreign customers. The demand for this form of insurance is also modest, because most of Indonesia's exports are traded on the basis of letters of credit. About half a per cent of Indonesia's non-oil and gas exports are covered by the scheme.

Tax incentives

Income tax rates are the same for all taxpayers, both corporate and individual. The current rates are: 15 per cent on the first Rp10 million ($A7000) of taxable income; 25 per cent on the next Rp40 million ($A28 000); and 35 per cent on all other taxable income. A value-added tax (VAT) and sales tax on luxury goods came into effect in 1985. There is a single VAT rate of 10 per cent.

All exporters are eligible for a refund of the VAT incorporated in the purchase price of inputs used in producing exports. Additionally, firms which export greater than 65 per cent of their production are exempt from a luxury tax being levied on inputs. They are also granted tariff exemptions on imported materials (not including fuel, lubricants and factory equipment). Manufacturers may also be eligible for duty drawback on the imported goods used in exports. Duty drawback also applies to imports that are exported without reprocessing.

Export processing zones

There are two EPZs at the moment. The first is located in the main port area of Tanjung Priok (Jakarta). The second is on Batam Island, 20 kilometres south-east of Singapore. Batam Island has been designated as an industrial growth centre and a duty-free zone by the Indonesian Government. The island is 415 square kilometres in size, has a population of about 100 000 and enjoys a strategic location near Singapore. The objective is to take advantage of Indonesia's abundant land and labour resources in combination with Singapore's entrepreneurial skills and organisational abilities, such as its expertise in industrial estate management and efficient logistic support, including a global marketing network.

A 500 hectare industrial park has been constructed on the island, along with extensive supporting infrastructure -- including a port, utility services and ready-to-go factory sites. The park is a joint venture between an Indonesian company (the Salim Group) and two companies owned by the Singaporean government (Singapore Technologies Industrial Corporation and Jurong Environmental Engineering, a subsidiary of Jurong Town Corporation).

The Indonesian Government has announced plans for large-scale economic development of the island, including development of tourist facilities. These developments are now well under way. Indonesian workers are provided with low-cost accommodation and transport to Batam.

The Government hopes that foreign and Singapore-based companies will be attracted by the island's low operating costs and high quality facilities relative to the rest of Indonesia.

III.4 Effects of Indonesian export enhancement measures

In the last few years, Indonesia's export enhancement measures have been primarily directed at offsetting domestic distortions which would otherwise prevent potential exporters from obtaining needed inputs at world prices. In this sense, the measures seem to be striving as much to offset existing distortions in the economy as they are to positively encourage exports.

As with the export enhancement measures of many other countries studied by the Commission, there is a dearth of analysis of the effects of Indonesia's export enhancement measures on the domestic economy.

An Asian Development Bank study (ADB 1990) of Indonesia's export finance system argued that the availability of subsidised credit stifled private sector activity in this area:

> As long as funding at a preferential rate is available from the central bank, commercial banks will have no desire to finance export credit.

As for Indonesia's export insurance system, the same study found that:

> ... [because of] the voluntary nature of export insurance ... the propensity to cover has remained weak .... As a consequence, economies of scale which serve as a basis for a good risk spread in any insurance business is simply lacking.

On the contribution of subsidised export finance to export growth, the ADB concluded that:

> ... [the] availability and ready access to export finance are extremely significant while subsidised export finance is relatively less important to export growth.

The ADB also found with regard to incentives schemes in general:

> ... given the poor capability of the Indonesian bureaucracy, it is not advisable to follow the pattern set by the NIEs in providing direct incentives to exporters because of the inherent risk that these incentives will not be granted to the most worthy exporters.

III.5 Concluding comments

Indonesia has experienced a rapid improvement in its export performance since the beginning of economic deregulation in the early 1980s. This growth has been concentrated in resource- and labour-intensive products. In particular, three manufactured exports have been dominant: plywood, textiles and clothing. These exports have accounted for some three quarters of the total. Textiles and clothing production has been attracted by Indonesia's low labour costs and resource availability.

It appears more likely that Indonesia's improved export performance can be attributed to getting the fundamentals right (in the sense that the macroeconomy is being managed more effectively than before) than to specific export enhancement measures. Such measures have principally concentrated on attempting to achieve trade neutrality for exporters, for example, by giving them access to needed inputs at world prices. Nevertheless, many distortions remain, including a significant element of deliberate government intervention in support of `strategic' industries. Future potential also continues to be hampered by uneven access to high-quality infrastructure.

As with many other developing economies in the region, political and economic stability (rather than gimmicky export enhancement measures) appears to be a significant draw card when it comes to attracting foreign direct investment in Indonesia.

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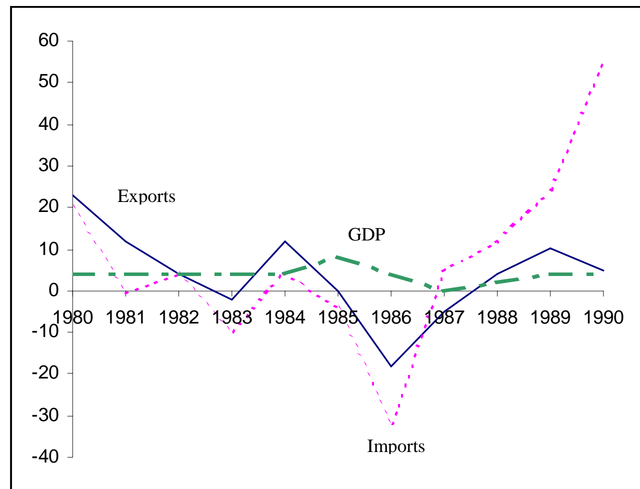
Overseas Export Enhancement Measures

IV JAPAN

Japan emerged from World War II with its economy devastated. Yet, over the period of four decades, it has achieved a remarkable revival to become the world's second-largest economy. Until the mid-1970s, export enhancement measures featured as key instruments of Japan's trade and industry policy. In recent years, however, the policy focus has shifted from export to import enhancement.

Japan's peak economic growth occurred in the 1960s and 1970s with GDP increasing over this period by a factor of over 14. Although the pace of economic growth slowed over the period 1980-90, it continued to be strong, averaging 4.3 per cent a year in real terms (see Figure IV.1).

Figure IV.1: **Japan's growth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: IMF 1991

IV.1 Trade performance

In the expanding world economy, Japan has been a particularly dynamic factor, increasing its share of world exports from just over 1 per cent in 1950 to more than 9 per cent in 1990 (IMF 1987, 1991). Japan now ranks as the world's third largest merchandise exporter (behind the United States and Germany), and the sixth largest exporter of commercial services. Japan's share of world merchandise imports has been around 6 to 7 per cent over the past two decades, making it the world's third largest importer (GATT 1990).

Over the past decade, Japan has had large external imbalances, with the current account surplus rising from 0.5 per cent of GNP in 1982 to 4.5 per cent in 1986, and then falling to 1.3 per cent in 1990. These surpluses have been the source of considerable friction between Japan and its trading partners, especially the United States and EC member states.

Manufactured goods make up 96 per cent of Japan's total merchandise exports, with agricultural products contributing less than 1 per cent. Within the manufacturing category, exports are concentrated on a small number of products. Office machinery, telecommunications, automotive products and electric and non-electric machinery account for nearly two-thirds of merchandise exports -- see Table IV.1.

Table IV.1: **Merchandise exports from Japan: 1989**
(Per cent)

Other machinery and equipment	37
Motor vehicles and parts	22
Metals	8
Office machinery	7
Chemicals	5
Electronic components	5
Scientific and optical equipment	4
Textiles	2
Other	10
Total Merchandise Exports	100

Sources: Ernst and Young 1991

There have been significant changes over the past four decades in the shares of exports by end use, reflecting the growing specialisation of Japanese industries in more sophisticated, high-quality products. While in 1965 industrial supplies accounted for the largest share of exports (followed by capital and consumer goods) by 1989 capital and consumer goods accounted for 75 per cent -- see Table IV.2.

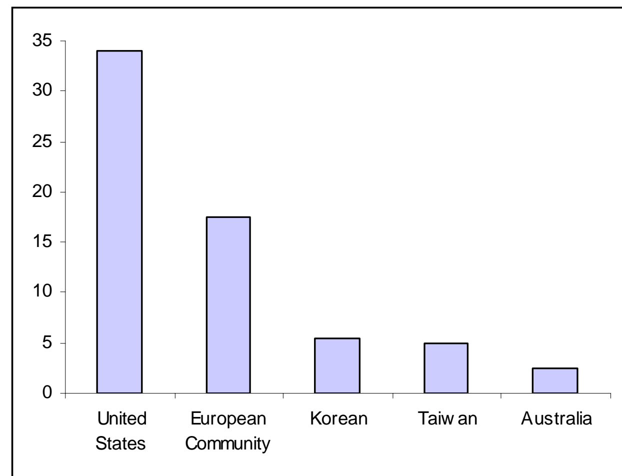
Table IV.2: **Changing composition of Japanese exports**
(Per cent)

Type of export	*1965*	*1970*	*1980*	*1985*	*1989*
Capital goods	28	31	40	46	54
Technology-intensive products [a]	na	na	na	6	9
Consumer goods	21	26	28	31	25
Passenger cars	1	5	12	14	14
Industrial supplies	45	38	28	20	18
Textiles	12	8	4	3	2
Iron and steel	15	15	12	8	5

a Includes data processing machines, integrated circuits, and telecommunications equipment.
na Not available
Source: Japan Tariff Association 1991

Japan's most important trading partner, both as a source of imports and as a market for exports is the United States, followed by the European Community. Figure IV.2 shows major destinations of Japan's exports.

Figure IV.2: **Major destinations of Japan's exports: 1990**
(Per cent)



Source: GATT 1990

IV.2 Trade and industry policy

A chronic scarcity of natural resources in the aftermath of World War II led the Japanese Government to adopt an outward policy orientation -- export to fund the import of natural resources (Sato 1986). Re-establishing trade links and export growth were policy priorities. Trade and industry policy advice was made the responsibility of the Ministry of International Trade and Industry (MITI) in 1949.

The early 1950s

Japan's economy waxed and waned. The rapid growth that came with the Korean War (1950) faded away, and the recession that followed prompted the Government to re-focus economic objectives -- expansion through export growth became the driving force of much policy. In 1954, the Export Conference, chaired by the Prime Minister, was set up to co-ordinate the export drive, develop specific export promotion measures and set targets for each industry and product (see Figure IV.3). A major export drive and a new export insurance scheme were initiated. The Bank of Tokyo was established as a specialised foreign exchange bank, and in 1954 the Japanese External Trade Organization (JETRO) was set up to promote exports.

The Economic Planning Agency issued a `New Long Range Economic Plan' in 1957, focussing on export promotion. Export incentives were boosted through priority financing, improvements in export insurance, tax incentives and improvements to the trade and exchange control system. The Plan targeted assistance towards sectors considered to have the best prospects for employment and export performance: these were the heavy and chemical industries and the machinery industry.

The growth of exports was remarkable, increasing from 3.5 per cent of GDP in 1950 to over 9.4 per cent by 1960. Japan's share of world exports over this period increased from 1.4 to 3.4 per cent (IMF 1987).

The 1960s

The 1960s saw a policy shift towards less direct controls. The `National Income Doubling Plan' of 1960 emphasised the role of the private sector as a driving force in economic growth. It aimed to strengthen Japan's infrastructure base, improve science and technology and to modernise the industrial structure. It marked the beginning of a period of trade liberalisation. Shiraishi (1989) noted:

> What gave support to the plan was the expansion in exports and changes in the structure of the export trade along with attempts to improve trading relations with other countries. Export promotion policies were pursued in terms of the external and internal conditions at the time.

Export incentives introduced under the 1960 plan included provision of: a premium redemption on overseas transactions (ended 1967); tax incentives (through a reserve fund) for overseas market development for trading companies, small and medium-sized enterprises (SMEs) and overseas investments; special exemptions on overseas income; and tax deductions for export-related expenses. Financing of export promotion through JETRO was increased and export insurance arrangements were expanded through extended coverage and a 50 per cent cut in premium rates.

The economy entered a period of peak growth with the Iwato `unprecedented' boom of 1960-61 and then the `Olympic Games' boom of 1963. Exports in 1964 were 22 per cent higher than in the previous year and rose by a further 27 per cent in 1965. The prevailing view in MITI was that much of the economic growth could be attributed to growth in exports, and hence could be maintained by further boosting export promotion. In 1966, wide-ranging measures were announced by MITI's Trade Promotion Bureau. Shiraishi (1989, p. 176) summed these up as follows:

> ... export base: strengthen international competitiveness in production, improve shipping and harbour facilities, improve the quality and design of export products, promote exports by medium and small enterprises, examine the system of subsidies, improve overseas economic co-operation.
>
> ... On export markets: cultivate overseas markets; carry out market surveys, see to advertising and sales promotion, train trade personnel, collect and publicize trade-related material.
>
> ... On the export `spirit': prepare export targets, hold a national export campaign, set up an award scheme for export performance.
>
> ... On economic co-operation: study the markets in developing countries, improve public relations and advertising, promote capital and technical co-operation with developing countries and buy more of their primary produce.

The range of subsidies and grants available to promote exports was extended. The existing export trade bill scheme and the special guarantee scheme for exports of agricultural and marine products were supplemented through the Bank of Japan's `foreign exchange bill purchase scheme' which provided short-term export finance of exports. Medium-term finance was extended through the Export-Import Bank's contract scheme -- this applied particularly to exports of ships and plant. Policy making was notably fluid in regard to export enhancement measures, with annual budgetary revisions carried out in many cases. A revised export promotion tax scheme was introduced in 1964, a special exemption scheme on income of overseas dealings in technology was widened in 1965, and in 1966, the rate of export premium redemption was raised from 80 to 100 per cent.

Japan's economy experienced unprecedented growth through the 1960s, with GDP increasing nearly five-fold. Exports increased proportionately and accounted for over 9 per cent of GDP. Japan contributed 6.7 per cent of world exports in 1970 (IMF 1987). It is notable that Japan's high growth rate and rapid increase in exports coincided with a period of high growth in the advanced economies.

The 1970s

The Government's trade and industry policies in 1970 can be summed up as follows:

- promotion of trade and economic co-operation with other countries;
- improvement in industrial structure and business organisation;
- help for SMEs;
- promotion of technical development and advanced technology;
- development of domestic natural resources, anti-pollution measures and industry rationalisation; and
- consumer protection and modernisation of the distribution system.

Japanese exports continued their remarkable growth in the first half of the 1970s, despite slack in the domestic economy. However, world-wide economic growth faltered in the mid-1970s after the first oil price shock. In the early 1970s, many of Japan's export enhancement schemes were either scaled down or terminated (see Figure IV.3). The major changes were replacement of the Export Conference with the Trade Conference to broaden the former's activities to include import promotion, and a scaling down of the reserve fund for overseas market development to apply only to SMEs. The following export assistance schemes were terminated:

- the accelerated depreciation allowance scheme for exports (1961-72);
- the income depreciation allowance scheme for technical overseas trade (1959-72);

- the export finance scheme which provided rediscounting of trade bills through the Bank of Japan; and
- the special tax depreciation scheme for enterprises contributing to exports (1968-71).

The 1980s

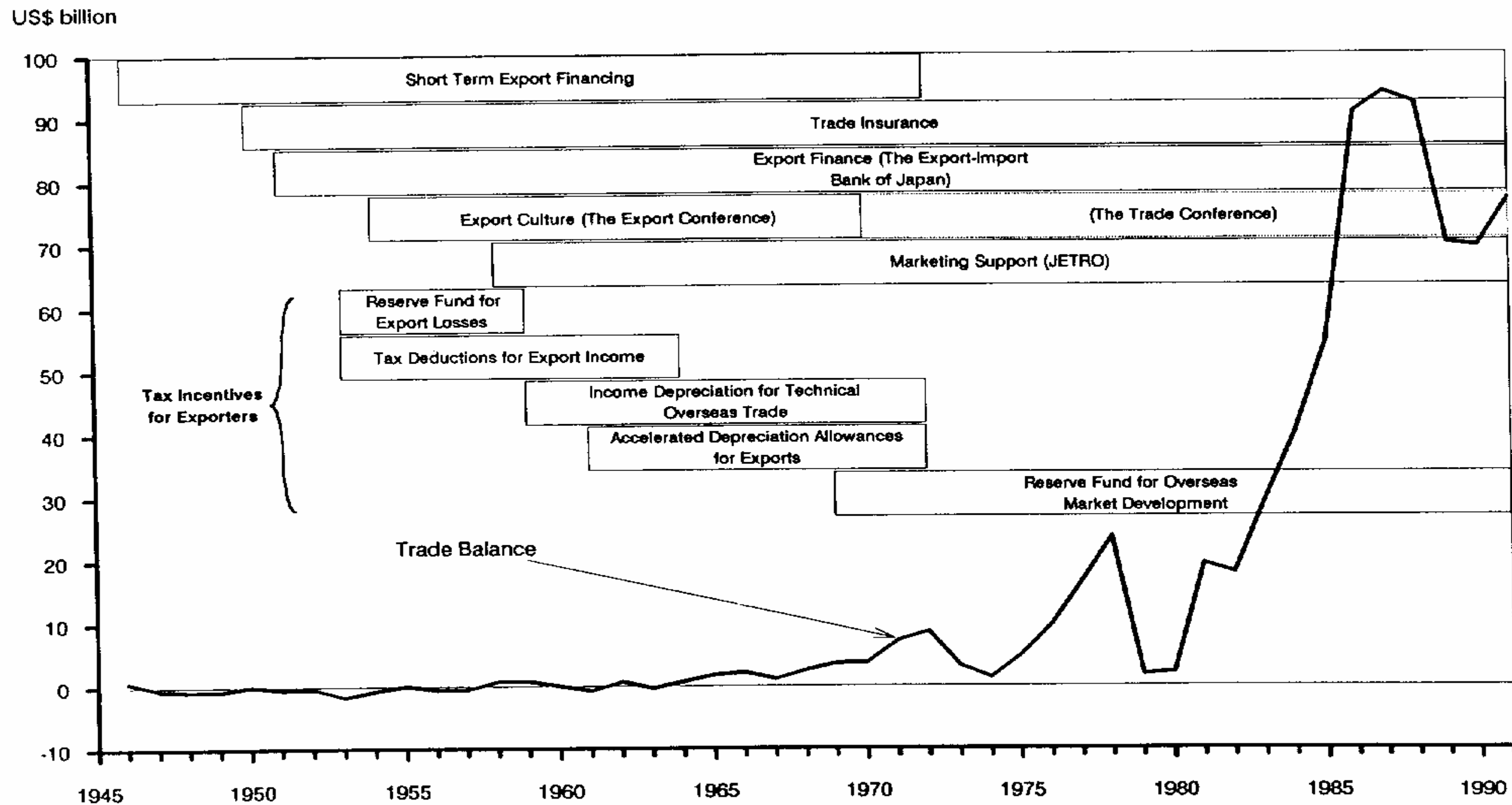
The trade frictions which emerged in the 1970s continued to fester and were highlighted by Japan's enormous current account surplus, which peaked in 1986. Partly in response to these pressures, the Government formulated its five-year economic management program in 1988 to facilitate the transformation of the Japanese economy away from export-led economic growth towards domestically driven growth, to shift Japan towards a more internationally harmonious trade and industrial structure, and to improve foreign access to the domestic market for imports of manufactured goods.

In the second half of the 1980s, Japan's competitiveness began to be eroded through the high value of the Yen, effectively slowing export growth and encouraging a surge in imports. The loss of competitiveness impacted mostly on the consumer goods sector. Combined with the effects of large outflows of Japanese direct foreign investment, this acted to reduce Japan's current account surplus. During 1990, Japan's current account surplus continued the downward trend it exhibited over the previous four years, to a level of about ¥5060 billion (A$45b)[1], or just over one per cent of GDP, although there has been some recovery in 1991.

The surplus-induced trade frictions with the United States and the European Community also stimulated the Japanese Government to increase imports. Early in 1990 it introduced its `Comprehensive Import Expansion Measures', which included some tariff reductions and import assistance. These `voluntary import expansions' (VIEs) involve directing companies to increase imports from designated countries and providing soft loans and tax incentives to Japanese companies which reach specific import targets. According to MITI, the Export-Import Bank of Japan and the Japan Development Bank provided import expansion loans to the value of ¥157 billion ($A1.4b) in 1990. The tax incentives effectively increased the imports of participating firms by 18 per cent, compared with firms not receiving the incentive whose imports increased by only 8 per cent (MITI 1992).

1 $A estimates used in this report are expressed in terms of 1990 Australian prices.

Figure IV.3: Japanese Government measures for export promotion, and the Japanese trade balance: 1946 – 1990



Source: Ministry for International Trade and Industry, Tokyo

IV.3 Export enhancement measures

The Japanese Government now employs few export enhancement measures. Indeed, it has developed an active *import* enhancement program. The remaining export enhancement measures of the Japanese Government are reviewed in this section.

Export marketing assistance

Japan's export marketing efforts are undertaken by both the public sector (through JETRO) and the private sector (through an extensive network of general trading companies). JETRO was established to promote Japanese exports through activities such as research, trade fairs, and intermediary services in trade transactions. Its functions were expanded in the early 1970s to include import promotion. Japan's ascent as a major economic force has reduced the justification for export promotion assistance and consequently, according to the Government, most of JETRO's efforts since the early 1980s have been directed at the promotion of imports (GATT 1990).

In 1990, JETRO's budget for specific industry trade promotion was around ¥643 million ($A5.7m) (MITI 1991). It operates through 78 overseas offices in 57 countries with 300 employees, and 30 local offices, staffed by around 600 employees. Its export services include motivation programs, information services, market research programs, foreign buyer programs and trade fairs.

The role of the general trading company in export promotion is an important feature of Japan's trading system. These companies actively promote and handle exports. They also provide financial and insurance services to firms producing for the export market. Characteristically, they have a broad international network, handle a wide range of products, and export about as much as they import.

Export finance assistance

Japan's export insurance assistance is administered by MITI, and export credits are extended by the Export-Import Bank of Japan (Eximbank Japan).

Export credit

Eximbank Japan's charter includes a mandate to provide support for the export of goods produced in Japan through the extension of finance facilities. It also operates programs for foreign direct investment, aid and, since 1985, for import credit. The main part of Eximbank Japan's business in fiscal 1990 was foreign direct investment credits which comprised 56 per cent of its credit commitments (compared with 25 per cent in 1984). Export credits accounted for 8 per cent of Eximbank Japan's total financing commitments of ¥1694 billion ($A15b) in fiscal 1989 (compared with 40 per cent in 1985). Around 2 per cent of Japan's total exports received export credit assistance.

According to the Japanese Government, the terms and conditions of all Eximbank Japan export credits conform with the OECD Arrangement: `the interest rate charged by the Bank does not fall below the interest rates charged for capital procurement, and this financing is therefore not concessional' (GATT 1990, p. 64). Eximbank Japan always lends to supplement private bank loans. The standard forms of export credit assistance are provided, including supplier and buyer credit as well as loans to other banks. The emphasis is on medium- and long-term loans of up to 20 years, and on lending to countries of above-average political risk.

Eximbank Japan also provides `technical services credit': long-term funds (over 12 months) to Japanese companies for the export of technical services -- including engineering and consulting services and construction activities. This credit is available where the export is made on a deferred-payment basis, or where payments are due on a progressive basis over a long construction period.

Export insurance

In 1989, exports to the value of ¥8383 billion ($A75b) or nearly 21 per cent of Japan's total exports were insured through the Export-Import Insurance Division (EID) of MITI.

MITI's EID operates standard insurance schemes to provide protection against the risks associated with exports or other international transactions, where these are not covered by existing private insurance institutions. EID operates with a capital fund of ¥17 billion ($A150m). Annual liability ceilings are fixed according to the type of insurance.

Research and development

Japanese R&D has been predominantly financed by private companies. In 1988, less than 5 per cent of the Government's R&D budget was aimed at industrial development. Of business enterprise R&D, less than 2 per cent was Government financed (compared with 33 per cent in the United States), and this share has steadily declined over the past decade (OECD 1990). Assistance is provided largely by way of grants and tax credits, with the main beneficiaries being shipbuilding (37 per cent) and petroleum refineries (5 per cent), neither of which is a significant exporter.

IV.4 Effects of export enhancement measures

Japan's economic growth has often been described (for example by MITI) as being `export-led', that is, caused by an increase in export demand. In this scenario, a marginal improvement in the

competitiveness of the domestic industry, say through an export incentive, can theoretically lead to a significant increase in exports. Other governments have found this view convincing and have attempted to emulate Japan's growth experience through the pursuit of similar export-enhancing policies.

There has been some debate as to the nature of this causal relationship. Some Ohkawa and Rosovsky (1973) have argued that Japan's export growth has been above the world average because the rate of growth of its economy has been well above the world average, and not the other way round. That is, the improvement in Japan's competitive strength in export markets was a by-product of its high rate of economic growth, itself caused by increases in industrial productivity. However, Japanese companies have shown considerable structural flexibility, enabling them to shift their production quickly between the home and export markets, so maintaining aggregate demand.

According to Ohkawa and Rosovsky (1973), the reason for Japan's export growth was primarily the decline in the relative price of its manufactured exports resulting from productivity gains in manufacturing. In other words, supply side factors (such as export prices, quality, product differentiation, and financing) were of paramount importance. In this situation it is highly unlikely that export incentives could have had much influence on Japan's rapid export growth.

Itoh and Kiyono (1988) also questioned the significance of Japan's export promotion policies. Noting that the tax system was perhaps the most effective instrument for promoting exports in the 1950s and 1960s -- the period of most rapid economic and export growth -- they showed that the size of incentives provided through the tax system amounted to no more than 1 per cent of the total value of exports. They postulated:

> If the effect of the export promotion policy is in fact so questionable, how can one look for an explanation for the high rate of export growth in postwar Japan. This explanation can perhaps be found, though paradoxically, in the rapid expansion of domestic markets ... Industrial development leveraged on an expansion of domestic markets was made possible by the availability of a large internal market aided by government protection through import restrictions and regulation of foreign investment ... the growth and development of such industries as automobiles, household electric appliances, pianos, and integrated circuits were sustained by domestic demand, and the products that developed in the process largely reflected the demand of Japanese consumers ... If this is so, domestically generated industrial development could be more effective *ceteris paribus,* than the export-led industrialisation.

As for the effectiveness of Japan's other major export enhancement measures, the evidence is patchy. In regard to Japan's export market development assistance scheme the Port Authority of New York (1988) noted that:

> In Japan, a majority of users, mostly the small/medium firms, reportedly think that the Government's services are well worth the modest costs. The more experienced exporters, however, apparently rarely approach the Government promotion agencies, mainly because their experience, expertise and commercial intelligence exceed the Government's. As bluntly stated by a major trading company official, `We never talk to JETRO, they have less people in the States than we do, really, we don't take JETRO very seriously at all'. These business people say that the activities of private, general trading companies, large and small, are the key to Japan's export success. In their view, the Government's biggest contribution to Japan's export success has been its ability to expand the number of export firms at the periphery of Japanese international trade (pp. 21-2).

A study by Fleisig and Hill (1985) of Government-sponsored export credit programs estimated the level of Japan's export credit subsidy for the period 1976 to 1980. They concluded that, in general, 50-100 per cent of the export subsidy provided through such programs was actually transferred to the borrowing country, resulting in a net loss to Japan.

This assessment points to a rather limited contribution of official export enhancement measures to Japan's economic success. What did make Japan so successful in economic terms? Fierce competition in the domestic market provided much of the push for Japanese firms to improve productivity and innovate. Although import penetration in many industries which were successfully exporting was low, the absence of competitive imports did not provide comfortable profits in the domestic market with which to finance export market developments. In Japan's most competitive export markets there was vigorous competition among Japanese companies for the domestic market.

The impact of VIEs on the Japanese economy is likely to be just the reverse of export enhancement measures in most respects. Japan's import promotion measures have similar effects to its supplier countries' export enhancement measures in that they boost bilateral trade. But they differ in that the bill is footed by Japanese industry and taxpayers, not their foreign counterparts. The GATT Secretariat has warned that VIEs could result in trade distortions, for example by favouring import growth from a particular source (GATT 1990, p. 275). Strikingly, MITI informs that about 82 per cent of the low interest loans for import expansion provided by the Export-Import Bank of Japan and the Japan Development Bank were used to increase imports from the US (MITI 1992).

IV.5 Concluding comments

The Japanese Government has employed several export enhancement measures in the past 40 years, but does not use many now. Today, assistance is provided largely by way of export credit.

Although the evidence is not conclusive, it does tend to suggest that Japan's remarkable economic growth over the past four decades can be largely explained by its dynamic and rapidly expanding domestic economy and not simply by the response of the economy to export demand.

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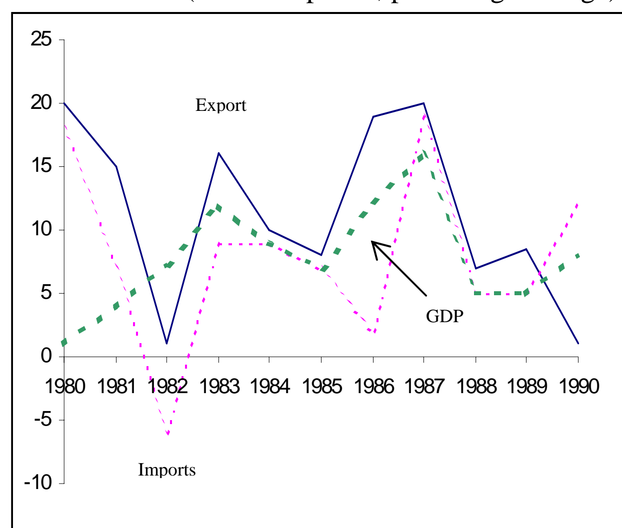
V REPUBLIC OF KOREA

Korea has limited natural endowments yet has achieved significant economic growth over the last 30 years. Over the 1980s real GDP growth averaged about 8 per cent annually. The exports-to-GDP ratio was 53 per cent in 1990, and the terms of trade showed consistent improvement through the 1980s. Korea now accounts for 2 per cent of world exports.

V.1 Trade performance

Exports increased strongly over most of the 1980s: averaging 10 per cent a year over the decade (Figure V.). Towards the end of the decade, however, there was a sharp deterioration in export performance with exports declining by 9 per cent in 1989. In 1990, the country ran a current account deficit equivalent to over $US2 billion ($A2.6b)[1], the first since 1985.

Figure V.1: **Korea's growth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: IMF 1991

This decline was due to several reasons. During the 1980s, the Won appreciated against major currencies as a result of Korea's consistent trade surpluses. Between the fourth quarter of 1986 and the middle of 1990, Korean export prices rose 34 per cent in US dollar terms.

Wage increases also contributed to the loss in competitiveness, as they far outstripped productivity increases -- partly in response to Korea's high inflation rate and partly as workers have increased their demands for more of the income gains. Wage growth rates in some sectors were as high as 30 per cent a year in the late 1980s. These were driven by chronic labour

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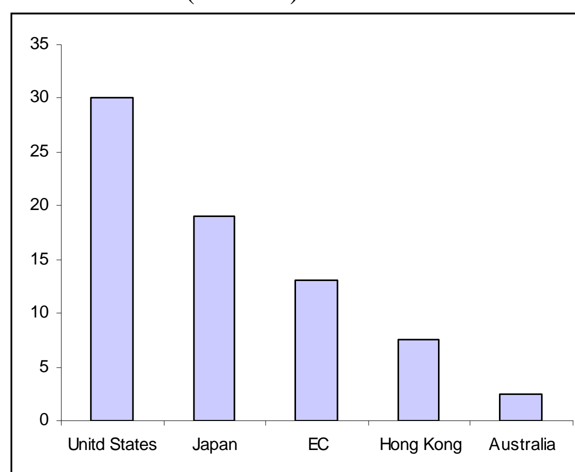
[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

shortages in some parts of the economy. For example, a boom in the construction industry had driven up wage costs, attracting labour away from manufacturing. There is some anxiety in Korea that export competitiveness will slump if advanced technology is not introduced to compensate for labour shortages and high wages. As Korean Trade and Business (1991, p.11) has noted:

> ... Korea's exports are losing their appeal because they are neither as technologically advanced as goods from developed countries nor as cheap as very similar goods from the newly developing countries which still have the advantage of a cheap labour force.

While Japan used to be Korea's main trading partner, it has been overtaken by the United States, which accounted for about 30 per cent of Korea's merchandise exports in 1990 (Figure V.2). At the same time, the number of countries Korea trades with has increased dramatically.

Figure V.2: **Major destinations of Korean exports: 1990**
(Per cent)



Source: KFTA 1991, p. 23

In 1990, exports were almost exclusively manufactures, accounting for 95 per cent of export income. Important contributors to this figure were textiles, clothing and footwear (30 per cent) and electronic goods (27 per cent) -- Table V.1.

Table V.1: **Merchandise exports from Korea: 1990**
(Per cent)

Electronic & electrical products	27
Textiles & clothing	23
Footwear	7
Steel products	6
Chemicals	4
Ships	4
General machinery	3
Motor vehicles	3
Plastics	2
Fishing	2
Other goods	19
Total	**100**

Source: KFTA 1991 p.22

V.2 Trade and industry policy

Korea's economic boom followed adoption of an export-oriented trade policy in 1961, which provided businesses with active incentives to export. An extensive national program influenced development, especially through a series of five-year development programs. The programs incorporated several features:

- the President oriented the entire machinery of government towards achieving export targets;
- the exchange rate was managed to maintain the country in a competitive position;
- *chaebol* (large business conglomerates), such as Samsung, Hyundai and Daewoo were promoted to the detriment of domestic competition;
- exports from labour-intensive industries, especially textiles and clothing were favoured. In particular, the Government offered preferential finance at low rates to exporters; and
- foreign debt capital was actively encouraged.

However, from 1973 the policy direction changed and the Government pursued a program of targeting strategic industries through the Heavy and Chemical Industries (HCI) policy. The favoured sectors were capital-intensive heavy industries such as shipbuilding, motor vehicles, iron and steel, petrochemicals and, later, electronic components. Several factors led to this large change in policy:

- it was feared that rapid wage increases would reduce Korea's comparative advantage in light manufactures;
- the easy access to capital goods under the earlier incentives had increased imports of them, and it was thought that this was stifling the development of domestic industry;
- the Government wanted to strengthen the industrial base of the economy to enhance national security after the withdrawal of US troops from Vietnam, as it feared that the same might happen to Korea; and
- the inclusion by the US of exports of Korean textiles in a 1971 trade-restraint agreement led to a push to diversify the export base.

Exports from some of the heavy and chemical industries eventually flourished. In 1979, they contributed some 80 per cent of manufacturing exports -- though by 1990 their contribution fell to about 20 per cent (Table V.1). Indeed, the steel company POSCO `is now lauded by the World Bank as arguably the world's most efficient producer of steel' (*Economist* 1991, p.6). However, eventual over investment in these sectors drew resources away from areas of comparative advantage, and the HCI policy is generally regarded as having failed, since it did not assist overall economic growth and it left a legacy of major imbalances and inflexibilities in the economy in the 1980s. To cite just one symptom, inflation in 1980 approached 40 per cent.

During the early 1980s, under US pressure the Government dropped its interventionist policy stance and introduced some market-based reforms. By the time of the development of the sixth five-year economic development plan in 1986, the Government saw increased reliance on market forces as the best way of achieving growth:

> ... free-market economic system is perhaps the best means of sustaining a cyclical process of increased production and improved distribution. As a result, every citizen can maximize his own production efficiency and a fair distribution can be achieved under the principles agreed upon by a majority of the people (Government of the Republic of Korea 1986, p.26).

Although the Government introduced many economic reforms in the 1980s, it chose not to free up all the protected sectors of the economy and it boosted assistance to technical development and R&D activities. It also reinforced marketing activities, product differentiation and new product development.

The Government announced new policy measures in March 1991 in response to an export-growth slump. The package aimed to buoy up Korea's export capacity in a four-pronged approach to:

- develop industrial technology;
- reduce labour shortages;
- create new manufacturing facilities; and
- create tax and financial incentives for investment.

The package incorporated increased investment funding, exemption from credit controls for targeted key firms, financial incentives for small and medium-sized businesses, more funding for high-technology education, and an increase in industrial sites. Unlike the 1970s, when the Government selected particular industries and companies, this policy package only designated particular technologies.

V.3 Export enhancement measures

Korea has used export enhancement measures more actively than other countries. The range of measures employed has included most of the measures documented in this report, particularly tax incentives and subsidised finance.

A key point to make about Korea's use of export incentives is the way the Governmental structure supported them and the use of `non-economic' tools to create an export culture. President Park started holding monthly export promotion meetings, where participants could review the current status of exports and note any problems they had encountered. The community was fed a steady diet of the importance of exporting, with export awards and targets also playing a role.

Export marketing assistance

The Korean Trade Promotion Corporation (KOTRA) was established in 1962 as a wholly government-funded, non-profit organisation. It provides broad trade promotional activities for business, including:

- trade fairs, promotions and consultations;
- introductions to foreign companies in order to develop countertrade deals; and
- training and education activities.

While KOTRA is the central trade promotion agency, other institutions have been developed to support trade promotion through close relations between Government and business. In particular, the Korea Foreign Trade Association (KFTA) is a private non-profit organisation established in 1946. Its functions are to provide information to Korean traders about foreign market opportunities and vice-versa, and to lobby the Government on behalf of trade-exposed business. It has 25 000 member companies, with membership being legally compulsory for firms doing business overseas. The fee is W50 000 ($A90) regardless of company size. KFTA owns Korea's World Trade Centre.

The Commission gained the impression from its visit to Korea that the KFTA, and the *chaebols'* own export development departments, considered they could usually handle export promotion activities better and more cheaply than KOTRA. But KOTRA runs 80 offices in 69 countries, and sees itself as performing a different function from KFTA, which has only four or five overseas offices. While KOTRA's role in the major markets like Japan and the United States has diminished, it is seen as having a role to play in other markets which Korean businesses hesitate to enter.

General trading companies

The Government introduced a system of general trading companies in 1975 which specialise in international marketing. The need for specialised trading companies grew out of the lack of efficiency of small-scale individual salesmanship on the international market and the tendency of Korean exporters to depend upon Japanese trading companies.

The main role of Korea's trading companies is to act as import-export agents. Other functions include finding new markets, gathering information related to trade, developing raw materials in foreign countries and investing in joint ventures.

Export finance assistance

Export credit assistance has been an important incentive in Korea since the 1960s, and it is now the main form of export assistance.

Today, the Bank of Korea regulates bank loans for export credit and several other institutions are also involved, notably the Export-Import Bank of Korea (Eximbank) and the Industrial Bank of Korea. Several finance packages are available, including:

- short-term credit;
- deferred payment finance for export; and
- credit for small and medium-sized enterprises (SMEs) which export.

Short-term credit rationing

The main type of financial assistance to exporters has been preferential access to credit. Under the direction of the Bank of Korea, commercial banks have been allowed to give export loans to companies on the production of a letter of credit from foreign buyers. Since the domestic capital market was heavily regulated until December 1988, and business generally suffered from a lack of credit, companies obtaining foreign letters of credit obtained a substantial advantage from this practice.

The Commission understands from its visit to Korea that this system of automatic access to export finance currently permits the banks to obtain central bank rediscounts of up to 50 per cent on a base interest rate of 7 per cent, which is a substantial concession. Loans are calculated either on the basis of letters of credit or actual export performance. The maximum finance terms are 180 days for funds provided on a letter of credit basis, and 90 days for funds against actual export performance. Currently the average loan amounts per $US worth of exports are 600 Won for smaller firms and 400 Won for medium-sized firms.

Medium and long-term export finance assistance

Established in 1976, Eximbank offers medium and long-term credits with deferred payment requirements for exports, overseas investment, and the development of natural resources abroad. The Commission understands Eximbank seeks to comply with the relevant GATT rules for such operations and that, while Korea is not a member of the OECD, it usually complies with the OECD Arrangement.

The credits cover pre- and post-delivery of export goods. Credit periods are as follows:

- up to 3 years for parts and components, and automobiles;
- up to 8.5 years for ships;
- up to 10 years for plant, airplanes, machinery, steel and steel products; and
- up to 5 years for other items.

Credits for SME exporters

A comprehensive export financing package is provided to SME exporters. It was introduced to allow these firms to avoid the complexities of the multitude of generally available export finance assistance measures. The interest rates actually offered to SMEs (as opposed to the cost of funds to the lending banks) were liberalised in 1988.

Commercial banks also make `facility investment loans' to SME exporters for construction, purchase and installation of domestically produced machinery and equipment, technology development facilities and technology licences. The credits cover 80 to 100 per cent of funding and are available for one to ten years. Finance is supported by the Bank of Korea, which gives rediscounts of up to 60 per cent.

Export insurance

The Government has provided export insurance and guarantees since 1976, administered by Eximbank, which is a member of the Berne Union (see Volume 1, Appendix D). Insurance commitments totalled about $US300 million ($A440m) in 1988, according to Ball and Knight (1990, p.153). Premium income was $US2.9 million ($A4.3m), while claim payments amounted to $US2 million ($A3m).

Tax incentives

The Government's main revenue sources are a value-added tax (36 per cent of tax revenue in 1990), personal income tax (26 per cent), and corporate tax (20 per cent). The VAT rate is 10 per cent, while the top personal tax rate is 50 per cent -- for incomes over W50 million ($A100 000). The corporate tax rate is 20 per cent for taxable profits under W100 million ($A200 000), and 34 per cent over that amount.

Tax incentives for exporters have declined in importance since the Government terminated its HCI policy. However, according to the Ministry of Finance (1991), a substantial range of generally available incentives is still provided to Korean industry, including deductible interest on foreign-currency export credits and:

- accelerated depreciation allowances;
- deductions for export marketing expenses; and
- rebates for research and development.

Depreciation

The Government allows companies to use accelerated depreciation for fixed assets directly used for export production in manufacturing, mining and fishing. On top of this, between 20 and 50 per cent of normal depreciation expenses are allowable as special depreciation charges, for assets that are used for 12-18 hours a day.

Tax incentives for export marketing

Exporters may treat reserve funds set aside for developing new markets as losses, to a limit of 1 per cent of foreign-currency receipts from export businesses, overseas technical services or international tourist agency business. After two years, such companies must start adding these reserves back to gains in three-year instalments. A similar incentive applies to reserves for export losses.

Tax incentives for research and development

The Government provides a large number of incentives for R&D activities, including deductions and credits for technology acquisitions, staff development and investment. These measures all apply to activities which may or may not be export-related.

To cite just one example, newly organised SMEs which undertake technology-intensive activities are exempt from tax on income accruing from such business for four years (including the year of organisation), and are only liable to pay half the normal rate of tax for the next two years. In addition, these firms pay only half the usual tax on property for five years, and on acquisition and registration for two years.

Infrastructure

The Government has subsidised the construction of industrial estates to varying degrees since the 1960s. Most recently, in its March 1991 industry statement, it undertook to supply 2700 hectares of industrial land during 1991 amongst other regulatory measures involving changes of land-use classification. As at July 1991, 76 industrial compounds had been set up by the Korea Export Industrial Corporation (apart from `free export zones', which are discussed separately below).

Businesses locating in these estates enjoy low land costs; adequate power and water supplies, using infrastructure which is 50 per cent government-financed; good road networks and various support facilities including special administrative support. Korean companies are eligible for several tax exemptions, and foreign-owned businesses attract company tax concessions under the Foreign Capital Inducement Act. Bonded warehouses and factories exist within industrial estates with the approval of the customs administration.

While there seems to have been no particular export requirement for companies locating in these estates, KFTA told the Commission that, taken together, industrial estates contributed about 50 per cent of Korean exports in 1990.

Export processing zones

Korea has two EPZs, established at Masan in 1970 and Iri in 1973. The Government established these centres to encourage direct foreign investment and exports. The zones are open to foreign-owned firms but joint venture firms are preferred. To operate a business in the zone a company must manufacture, process or assemble goods for export. Electronic industries dominate the zones.

Industries located in the zones can import raw and semi-finished materials duty free and benefit from simplified administrative procedures. Several support and service facilities are provided by the Government -- such as electricity, water, transport, telecommunications, stevedoring, packing, storage and machine repair and maintenance.

In addition the Government offers exporters the following incentives:

- easing of certain laws and regulations;
- on-the-spot completion of various administrative formalities;
- various tax exemptions and reductions under the Tax Exemption and Reduction Control Law (TERCL);
- waiver of sales tax and VAT imposed on locally sourced materials;
- firms may claim for expenses associated with exporting, up to a value of 50 per cent of export earnings; and
- special depreciation allowance for small and medium export manufacturers.

The Commission understands from its visit to Korea that the EPZs contribute only a negligible share of exports, and that there are no plans for new zones of this type.

Trade-related investment measures

Information about the Korean Government's use of TRIMs is scanty, especially for recent years. However, local-content requirements have been applied to foreign investors with wide discretion and selectivity (Wade 1990, pp. 138, 152). Until recently, the Government has not sought to attract much foreign equity investment into Korea, preferring that local businesses remain locally owned. The importance of TRIMs for foreign investment has declined as local industry has grown rapidly, especially the *chaebols*. The Commission was told on its visit to Seoul that the Government has removed many of its TRIMs requirements and that soon they will be abolished.

Research and development

While the Government assists technology improvements in manufacturing, and it is difficult to relate this directly to export enhancement, there is no doubt that increased export performance is an important underlying objective, particularly as wage pressures and exchange rate appreciation are

reducing Korea's international competitiveness in products embodying relatively `low' technology. The Korean Government, like others in East Asia, is attempting to emulate Japan's achievement and progress rapidly up the technology ladder so as to achieve high incomes.

The Commission learned on its visit to Korea that Government-sponsored research institutes have not been very effective in recent years, and from now on project progress will be checked by a market test: no subvention without partial industry funding. (Usually the Government provides funding for such projects on a 50:50 basis.) This requirement is intended to guarantee that the results will be used.

Total R&D spending in Korea amounts to 1.9 per cent of GNP, of which 17 per cent is funded by the Government. The March 1991 industry statement targeted R&D expenditure in high-technology areas to increase to 3-4 per cent of GNP by 1996, up from the 1989 level of 2 per cent. Amongst many other measures, the Government committed itself to spend 1.5 trillion Won (about $A3 billion) by 1995 to develop 919 items now imported. Further, the Government stated it would allow some Korean high-technology firms to defer payment of export credits, and that some technology developments would attract an extraordinary tax exemption period.

Duty-free imports

In the 1960s and 1970s, inputs used to produce export goods entered duty free and without quantitative restrictions. In addition, there was a wastage allowance which was selectively used to spur certain exports by increasing the share of imported input coefficients allowable for those exports, thereby giving producers duty-free imports that could be used for production for the domestic market. However, the liberalisation phase of the 1980s and the scaling back of tariff rates is reducing the importance of such measures.

Development of an export culture

President Park had much determination to build his nation through exports (Lee 1985, p.43). From December 1962 he presided over monthly export promotion meetings. These were attended by all high-level Government officials concerned with economic affairs, the presidents of all financial institutions and business associations, the top managers of leading export firms and trade associations, and experts on trade. Park used the meetings to identify the problems in export expansion and to provide workable prescriptions for their solution. In 1977, the focus of the meetings was expanded so that the Government emphasised imports as well. And since 1982, the meetings have taken place bimonthly.

Yung *et al* (1984) surveyed Korean firms to gauge the effects of these meetings. They found that `more than three-fifths of the firms considered the meetings to have significantly affected export performance'. The meetings were said to do this in two ways:

- by encouraging firms to meet and exceed targets; and
- by Government helping to accommodate firms in their efforts to export.

According to Yung *et al* (1984, p.34):

> The meetings thus contributed much to the flexibility of Korea's policies for export promotion, and to the rapid adjustment. Just as firms have been the agents of Government's larger objectives, so the bureaus are the agents, within limits, of helping the firms achieve targets.

The Korean Government has long collaborated with business in a system of export targeting. Firms have projected their export growth which, in aggregate, has shown the Government what to expect and what finance, infrastructure, and other demands would be placed upon it and the wider economy to support exports. But the targets have also served as incentives to firms, since they have sometimes been used as an informal basis for providing assistance. It has therefore been in the interest of firms to set and to achieve high targets.

Yung *et al* (1984, p.22) observed that:

> The head of the export promotion office in the Ministry of Commerce and Industry has at his side a computer print-out of progress against targets by industry and by firm. The data is for the preceding day, which is all the more remarkable when it is considered that most developing countries do not have aggregate information on exports for many months. That print-out is also broken down by geographical region. If sales in a region are not up to target, the Korean ambassadors there are recalled to find out what the problems are and what can be done to spur Korean sales. And in the foyer of the head office of the Korean Traders' Association is a big board tracking the progress of each industry toward its target. The export associations of each industry, the nodes for all information flows on exports, have their own boards tracking progress. So do the firms on the shop floors, where the workers -- dressed in uniforms that give all of industry a paramilitary air -- keep track of their firm's progress toward targets and of that by competitors.

When Korea's exports passed $US100 million on 30 November 1964, the milestone was marked by declaring Export Day. The focus of the celebration is the award of prizes at a large public gathering. There are President's prizes for being the number one exporter in an industry, for export merit as a small or medium-sized firm, and for exceeding a target by more than 50 per cent. There are Prime Minister's prizes for inventions, for excellence in design, for having a high reputation in exhibitions overseas, or for developing an export product of high quality. There are, in addition, industry medals and prizes awarded by various ministries. In 1987 the criterion was changed from exports to exports and imports (Wade 1990, p.148).

Taken in combination with the other measures described here, export awards have had quite an effect on Korean business culture. Anyone who had accumulated wealth via export activities was considered a patriot and was assured that he had the blessing of the Government. `This honour and encouragement bestowed on exporters has undoubtedly helped channel the best of the entrepreneurial class in Korea into export activities' (Yung *et al* 1984, p.31).

V.4 Effects of export enhancement measures

Korea's economic success and its Government's active use of export enhancement measures have led to a plethora of studies being undertaken to analyse their effect. This section addresses the economic effects of Korean export enhancement measures in several ways:

- the heavy and chemicals industry policy and its aftermath;
- the impact of export finance assistance;
- a quantitative analysis of the significance of subsidised credit and tax exemptions between the early 1960s and 1988;
- the importance of Korea's GATT membership and access to world markets;
- the significance of `non-economic' factors; and
- the effects on the Australian economy.

Effects of the Heavy and Chemical Industry Policy

The HCI policy that the Korean Government pursued throughout the 1970s is generally regarded as having been a failure, although some have suggested there were some bright spots. While some industries -- such as heavy machinery -- did not prosper despite continuing Government support, others (such as chemicals) thrived with government support and were eventually able to operate efficiently without it. Still others, such as semiconductors, prospered without special government support.

The Korea Development Institute has found that the short-run benefits from intervention often come at considerable long-run cost (Yoo 1990). This was particularly true of the HCI policy which caused:

- long-term high inflation rates;
- an oligopolistic industrial structure dominated by HCIs which have suffered from excess capacity;
- an underdeveloped light industrial sector, unable to supply the intermediate goods necessary for many of Korea's exports; and

- unstable and unbalanced growth between the domestic and external economies, subject to bottlenecks and uneven growth.

Although some analysts suggest that the HCI policy should be judged successful since many of the assisted firms are now highly profitable, Yoo (1990) found that the assisted industries achieved lower returns than unassisted industries. Additionally, Yoo (1989) noted that the increase in Korean exports was largely due to circumstances that could not have been anticipated at the time the HCI policy was formulated:

- there was a rapid increase in US imports resulting from an expansionary fiscal policy and a decline in personal savings -- factors which it would have been difficult for the Korean Government to anticipate;

- Korean exports received a big boost from an 8 per cent depreciation of the Won against the dollar in 1985 and the steep appreciation of the Yen and the Deutsche Mark since 1985; and

- US restrictions on Japanese imports diverted some US import demand to Korea. This happened to be especially favourable to the HCI industries.

Yoo (1989, p.30) further suggested that the economy might have worsened if the Government had not turned away from its HCI policies in 1979:

> If the industrial policy had been continued, it seems highly probable that the economy would have been irrecoverably damaged for the time being and could not have benefited from the above-mentioned external developments that contributed to export expansion in the 1980s ... Instead, one may look at the performance of an economy that was similarly situated in the middle of 1970s but did not pursue the same kind of industrial policy. Taiwan comes fairly close to such an example, and Taiwan did not suffer as a result. To the contrary, Taiwanese exports expanded faster than Korean exports.

It seems clear today that substantial direct encouragement of specific Korean industries has caused basic problems in the economy. It is now widely felt that Korea has had too little investment in light manufacturing industries.

Effects of export finance assistance

A Bank of Korea econometric study attempted to gauge whether the Government's export finance assistance measures in 1964-82 had influenced export levels (Lee 1985). It found that financial assistance had played an important role in the expansion of Korean exports, ascribing as the main reasons the extremely limited availability of bank credit, the low level of domestic savings, and high interest rates in the unofficial market. While Lee found that finance assistance was very important to Korean export growth, the most important contributor was the increase in fixed capital formation.

The study also had some criticisms of the effects of the Government's export finance assistance policy:

- some exporters over-borrowed because they obtained automatic credit approvals based almost entirely on the export documents regardless of their cash flow;
- the automatic eligibility for rediscount at the Bank of Korea reduced the scope for effective monetary policy;
- it exerted an undesirable effect on resource allocation because it helped make capital relatively cheap and it induced the adoption of capital-intensive technology in a country with abundant labour; and
- it was executed mainly with a view to maximising producers' profits and foreign currency earnings, more or less neglecting the welfare of consumers in the short run.

Export credit insurance appears to have had little impact on Korean exports.

Effects of subsidised credit

The Commission has used its WEDGE model of the world economy to examine the economic effects of some of Korea's export enhancement measures between the early 1960s and 1988. This period was selected as it compares the end of Korea's pursuit of a general import-substitution strategy with the recent past (at least as recent as possible, given the lags that always bedevil publication of input-output tables). For comparative purposes, tariff liberalisation and labour-productivity improvements were also simulated. Further details of the study are provided in the attachment to this chapter.

In summary , the simulations show that subsidised credit for exporters was successful in promoting exports from manufacturing industries. However, this did not translate into any large change in national income. A labour productivity improvement of 40 per cent uncompensated by real wage increases resulted in as much of an increase in exports as the export subsidies examined. In sharp contrast to the export-related programs, the productivity improvement produced significant real gains for the Korean economy and resulted in a significant boost to overall welfare. Import liberalisation had the most dramatic effects on export levels, increasing Korea's volume of exports by almost three times as much as in the other simulations. It must be noted that these results do not suggest that export enhancement has been more vital to Korea's economic development than has import liberalisation.

* * *

It is widely held that Korea's economic success would not have been possible without `decisive and innovative policies', including strong export incentives, direct credit and a host of `finely tuned, export promoting instruments'. Park (1988) argued that export promotion was a necessary part of Korea's success. He qualified this support by contending that:

> ... the Korean Government granted too many incentives for exporting activities for too long. This discouraged the private sector from substituting domestic production for imported intermediate goods, parts and components, and capital equipment because imports were available on preferential terms.

The majority view in the literature is that, while it is true that a combination of factors have contributed to Korea's growth, the Government's willingness to offer export incentives and, significantly, not to pursue policies which might reduce export potential has greatly contributed to growth and improvements in the standard of living.

> Probably, the government's greatest contribution was its willingness to reconsider policies once they were found not to work. The ultimate criterion for policy decisions was economic performance, and economic policy flexibility adapted to the changing domestic and international circumstances. The flexibility in economic policy was ironically a product of an authoritarian government. Having come into power with the questionable legitimacy, the previous two governments relied heavily on economic performance to build and maintain their legitimacy. The power elite left the economic decision-making largely in the hands of technocrats. Korean technocrats and bureaucrats, in general, have not had strong vested interests in the welfare of certain social classes, sectors or industries of the economy. Their policy choices were also guided by overall economic performance (Yoo 1989, p.32).

Even given the costs associated with providing assistance, it is clear from the Commission's Korean visit that many -- but not all -- policy makers there firmly believe that export incentives have been of overall benefit. However, there is a distinction between incentives granted over a long period, which encourage dependence, and incentives for the short term, which can beneficially divert business attention towards exporting. Such assistance can only be effective if it is systematically lowered to avoid unproductive activities.

Significance of Korea's GATT membership and access to world markets

Korea is now at the stage where trade liberalisation is important to its prospects for continued economic growth. Membership of the GATT and the fear of countervailing actions restrain the Government from escalating its assistance to exports. The Commission's impression from its visit to Korea is that, if the GATT did not exist, the Government might see a role for non-selective export enhancement measures. Korea's GATT membership has influenced both the reduction in export enhancement measures and inhibited reintroduction of them.

Young (1989) noted that Korea's developing-economy status has provided the international legal justification for many of its trade policies. Korea has claimed special and differential treatment in the international trading system since its accession to the GATT in 1967.

It has been suggested that changes in Korea's export enhancement policies have been necessary to obtain or gain market access, and this has ruled out violating international rules. US pressure has been influential. For example, the Commission learnt during its visit that the Korean Government ensures that its support for the shipbuilding industry -- the world's second largest -- complies with the OECD Arrangement lest the United States apply countervailing duties on Korean exports.

Others make the point that it is no longer desirable for Korea to have the export measures it used in the past: the economy is now too big and too complex. Nor would it be feasible due to pressure from the United States and, to a lesser extent, from the GATT. Many Korean economists now think that it is better to let market forces operate than attempt Governmental management, not least in view of the HCI policy's failure in the 1970s.

Korea has attuned its trade policies more in accordance with GATT rules. It has given up its right to apply restrictions on the balance-of-payments grounds available to developing countries.

Significance of `non-economic' factors

The export enhancement program of the 1960s appeared to work. Which parts of the program mattered is difficult to evaluate, especially as several of them -- such as export meetings and awards -- were `non-economic'. The important point is that, from a situation where any form of business was not held in much esteem, what emerged in Korea was acceptance by the wider community that exporting should be a national vocation.

WEDGE also produces information on changes in the other regions it models. Impacts on the Australian economy were negligible in all three simulations. The Commission chose Korea as the subject of its modelling effort for this report because many observers have suggested it has had the most effective export enhancement measures (or at least as effective as Taiwan's, an economy which is not modelled separately in WEDGE). But the small size of the Korean economy, its relatively small economic linkages with Australia, and the concentration of its exports into goods and services not much exported from Australia combine to render changes in its trade and industry structure of little consequence to the Australian economy.

V.5 Concluding comments

The Korean Government has severely curtailed its use of export enhancement measures in recent years. It still provides export marketing and finance assistance, tax incentives, R&D assistance and subsidised infrastructure. It also has some TRIMs and maintains two EPZs, but these have become less significant. Most importantly, though, the Government has created an export mentality among local businesses, through the use of these incentives coupled with export targets, meetings and awards, and a readiness to tailor overall policy to foster export competitiveness. In this respect, the

current policy emphasis is on deregulating the financial system, reducing tariffs and other barriers to imports, and generally `freeing up' the economy. The Government is also encouraging the development of high-technology industries.

Korea's export enhancement policies have not been an unqualified success. While they have stimulated exports, the Commission's modelling suggests that they have not contributed much to Korean income.

Attachment: Effects of subsidised credit on the Korean economy

The Commission has used its WEDGE model of the world economy to examine the economic effects of some of Korea's export enhancement measures between the early 1960s and 1988. This general equilibrium model accounts for production, consumption and trade in 34 product groups between nine regions, including Korea (the model is outlined in Box V.1 and further described in Industry Commission (1991)).

Box V.1: **WEDGE: a multisectoral model of the world economy**

WEDGE is a `computable general equilibrium' model of the world economy. Its structure is very detailed, accounting for production, consumption and trade in 34 product groups between nine regions, including Korea. The model was first used in the Commission's inquiry into Australia and the Greenhouse Effect, and is further described in Industry Commission (1991).

WEDGE falls into the same category of models as the Commission's ORANI model of the Australian economy. It can be thought of as a series of country models, including one for `the rest of the world', between which goods and services trade is modelled using standard theory.

The model's main strengths are that it is constrained to ensure that everything adds up -- so that, for example, no more labour can be used than actually exists -- and that it overcomes the caveat usually associated with economic models: `all other things being equal'. Being a general equilibrium model, WEDGE allows repercussions to occur in all manner of economic variables to flow from the policy change under consideration.

The model's principal weaknesses are its inability to track the time path of economic changes and its failure to account for international capital flows.

Some important qualifications apply to this study. First, it was assumed that:

- real wages are held constant, although this is designed to reflect the Government's ability to maintain low growth in real wages compared with the growth of labour productivity; Amsden (1989) shows that labour productivity increases over the period 1965-85 exceeded real wage increases by 40 per cent; and

- there was a fixed aggregate capital stock in each region: the rental price of capital adjusted to clear the market for capital.

Box V.2: **Closure of the WEDGE model**

The `closure' of the model defines the economic environment that firms, households and governments are assumed to face in their responses to changes in policies. WEDGE simulations in this report use a medium-run closure. This represents a period long enough for primary factors to be reallocated between industries in each economy while factor endowments across regions remain unchanged. The main features of the closure include:

- a fixed employment rate in all regions except Korea: wage rates adjust to clear the labour market;

- fixed real wages in Korea to reflect the Government's ability to maintain low growth in real wages compared with the growth of labour productivity: the supply of labour adjusts to meet industries' demand for labour;

- in each region, it is assumed that there is a fixed aggregate capital stock: the rental price of capital adjusts to clear the market for capital;

- capital use by industries varies, adjusting to relative rates of return across industries;

- aggregate real investment is fixed;

- household savings adjust, allowing a fixed ratio between the balance of trade and net domestic product to be maintained;

- real aggregate government consumption and transfer payments move in line with movements in net domestic product;

- income tax rates adjust to maintain a fixed ratio between government budget deficits and net domestic product; and

- nominal exchange rates are fixed: the WEDGE model is based on real flows and monetary factors are assumed not to affect them.

Second, the WEDGE model is *comparative static* -- enabling comparison of two points in time, as by the Commission in this study. But it cannot simulate the effects of policies applied between those dates. The many policy changes applied between the early 1960s and the late 1980s, notably the HCI policy of the 1970s, as well as the intervening high levels of subsidised credit, are therefore not modelled in this study, which will therefore understate the effects of the Government's export enhancement policies. Thus the results should be interpreted only as indicating the likely outcome of applying subsidised credit in the latter period.

The economic environment assumed in this study is described in Box V.2.

As a comparative static tool, the WEDGE model is well adapted to compare the Korean economy in two different periods. It can be used to explain the part that trade and industry policies have played in the dramatic change in Korea's ratio of exports to income. But the model cannot account for the effect of policies which have biased the accumulation of capital. Similarly, the model does not provide information on the effect of trade and industry policies applied in the intervening period, such as the HCI policy of the 1970s which will have skewed the allocation of investment at that time, with lasting additional effects on the composition of Korea's capital stock. The same applies to the credit subsidies that applied prior to 1988. These dynamic effects certainly contributed to the structure of Korea's economy as it was in 1988 at the end of the study period. Because it does not account for these effects, the analysis here understates the effects of Korean export enhancement policies.

The period selected compares the end of Korea's pursuit of a general import-substitution strategy with the recent past. In the early 1960s, exports of goods and services accounted for almost 6 per cent of GNP. By the late 1980s, the ratio of exports of goods and services to GNP had increased to about 43 per cent. Some of the key differences between these two periods which may explain the export growth are listed in Table V.2.

Table V.2: **Comparison of selected economic indicators and policies in Korea: early 1960s and late 1980s**

Indicator	*Early 1960s*	*Late 1980s*
Exports/GNP (%)	5.7	42.8
Average manufacturing tariff(%)	38.2	12.6
Export enhancement programs	none	Credit subsidies/tax exemptions
Real wage (index)[a]	100	588
Labour productivity (index)[a]	100	980

a Based on Amsden 1989.

Simulations

This analysis is comparative-static: it compares the Korean economy observed in 1988 with what it would have been had the policy environment been different. The alternative policy environment chosen is the one that prevailed in the early 1960s. Three simulations are reported on the effects of:

- higher export credit subsidies;
- a 40 per cent increase in labour productivity in manufacturing; and
- decreased import tariffs on manufactures

in 1988 compared with the early 1960s. (Since the model's database pertains to 1988, the simulations actually involved reverting to the 1960s, rather than moving forward in time. But they are reported here as the change from the early 1960s to the late 1980s.)

The second and third simulations have been reported to provide a context in which to assess the first, which is the one of major interest to this inquiry. Each simulation is designed to assess the contribution of a particular element of policy to Korea's current economic structure.

The first simulation evaluates the contribution of subsidies on firm costs unrelated to Korea's import-protection regime. Estimates of the 1988 levels of these subsidies are reported in Table V.3. The simulation shows the impact these subsidies had on Korea's 1988 structure.

The Commission has estimated the 1988 export subsidy equivalents of Korean Government credit subsidies (together with commodity tax exemptions) to several manufacturing industries. Table V.3 reveals that the

Table V.3: **Export subsidy equivalents of subsidised credit in Korea: 1988**
(Percentages of export values)

Product group	*Export subsidy*
Non-metallic mineral products	7.1
Petroleum and coal products	5.8
Chemicals, rubber and plastic	5.1
Pulp, paper and printing	4.4
Other metals and products	4.2
Primary iron and steel	4.1
Other machinery and equipment	3.4
Other manufacturing	3.4
Transport equipment	3.0
Spinning and weaving	2.9
Beverages and tobacco	2.4
Lumber products	2.4
Leather and fur products	1.2
Apparel	1.0

Note: The credit subsidy is relatively large because Korea's financial system is a credit-based system (Wade 1988). The credit subsidy was calculated assuming that firms have a debt to equity ratio of 300 per cent. Westphal and Kim (1982) indicated that preferential interest rates on credits used in export activities were about half the interest rate of other credits. Thus a 50 per cent subsidy was assumed to apply to capital in proportion to the share of a firm's exports in its output.

Source: Estimated for the Commission's WEDGE model database.

subsidy rates for 1988 were low relative to earlier levels such as those reported by Westphal and Kim (1982) for the 1970s. The Commission understands, moreover, that subsidies were exceptionally low in 1988.

The second simulation provides an estimate of the contribution of unrewarded labour productivity improvements to Korea's economic structure. Between 1965 and 1985, the growth of productivity and real wages in manufacturing diverged by a massive 40 per cent. This simulation is a 40 per cent increase in labour productivity in manufacturing industries.

The last simulation estimates the contribution of lowered import barriers to Korea's economic structure. Estimated nominal rates of protection for Korean manufacturing for 1963 and 1988 are reported in Table V.4. The simulation shows how import liberalisation has impacted on the Korean economy in 1988.

Table V.4: **Nominal rates of protection in Korean manufacturing**
(Per cent)

Product group	*1963a*	*1988b*
Beverages and tobacco	36.3	17.0
Spinning, dying and made up textiles	39.6	14.0
Wearing apparel	39.6	17.2
Leather, fur and their products	39.6	10.1
Lumber and wood products	39.6	14.4
Pulp, paper and printing	39.6	4.7
Chemical, rubber and plastic	45.5	11.6
Petroleum and coal products	45.5	8.5
Non-metallic mineral products	45.5	15.2
Primary iron and steel	45.5	7.6
Other metals and products	45.5	11.5
Transport industries	36.3	5.5
Other machinery and equipment	39.6	14.2
Other manufacturing	39.6	12.3

a Adapted from Hong 1988.
b WEDGE database.

In this discussion, the change in the ratio of exports to GDP is used to measure how much of the change in Korea's economic structure between the early 1960s and the late 1980s can be accounted for by the trade and industry policies under scrutiny.

Changes in real household disposable income are used as the main indicator of welfare. Such changes can occur in the WEDGE model through:

- a reallocation of resources from subsidised industries to industries that are economically more efficient, which results in higher aggregate output and income;

- changes in the terms of trade which indicate how much a country must pay for its imports and receives for its exports; and

- productivity improvements which increase the set of production possibilities.

Export enhancement simulation

From a macroeconomic stand point, the WEDGE model shows that subsidies linked to the export of manufactured products increased exports by an estimated 4.3 per cent, but real disposable income by less than 1 per cent (Table V.5, column 1).

This is due to the decrease in Korea's terms of trade. Korea is a small country in the world economy. It does not influence the price of its imports in spite of a significant increase in its import usage (+3.4 per cent) -- especially intermediate inputs -- to produce new exports (+4.3 per cent). In the model, exports are differentiated geographically. Therefore, the price of Korean exports needed to fall slightly in order for foreigners to shift toward Korea's exports. The resulting 0.8 per cent decline in the terms of trade hampered the growth of real disposable income.

The initial effects of introducing export subsidies for manufactures were to decrease sale prices of manufactured exports but to increase the prices received by producers. Lower export prices induced higher demand for Korean exports, while higher factory prices led to increased manufacturing output. Increased factory prices attracted capital and labour away from primary and service industries.

Table V.5: **Contribution of trade and industrial policies to Korea's macroeconomic structure**
(Percentage changes)

Economic variable	*Export enhancement*	*Labour productivity*	*Import liberalisation*
Real GDP	0.4	3.7	2.9
Real disposable income	0.3	7.5	1.8
Export volume	4.3	8.9	20.9
Import volume	3.4	7.5	17.6
Employment	1.0	8.1	6.3
Consumer price index	1.8	3.0	-1.1
Export price index	-0.8	-1.3	-4.6
Import price index	..	..	..
Terms of trade	-0.8	-1.4	-4.6

.. less than 0.05.

Manufacturing output increased by 2.6 per cent and export volumes by 8 per cent, while output in the other sectors of the economy fell (Table V.6).

Table V.6: **Production and export volume changes due to certain export enhancement measures in selected Korean industries**
(Percentage changes)

Industry or sector	*Output*	*Exports*
Industries		
Beverages and tobacco	0.4	3.4
Spinning, weaving, etc.	1.7	6.1
Wearing apparel	-1.0	-1.7
Leather, fur and their products	0.8	1.4
Lumber and wood products	0.9	6.9
Pulp, paper and printing	0.9	9.3
Chemicals, rubber and plastic	1.8	12.1
Petroleum and coal products	1.6	14.0
Non-metallic mineral products	2.9	28.7
Primary iron and steel	4.5	12.5
Other metals and products	5.1	15.6
Transport industries	5.0	13.2
Other machinery and equipment	4.4	10.1
Other manufacturing	3.5	8.9
Sectoral results		
Primary	-0.6	-5.7
Manufacturing	2.6	8.1
Services	-0.2	-7.7

Labour productivity simulation

The increase in labour productivity increased the general level of economic activity in Korea: real GDP increased by 3.7 per cent (see Table V.5). As the level of output increased, additional imports were needed -- import volumes increased by 7.5 per cent. To re-establish external balance, Korean exports increased by 8.9 per cent, although export prices fell by 1.3 per cent. In spite of a fall in Korea's terms of trade (-1.3 per cent), the gains from increased productivity were so large that real disposable income rose by 7.5 per cent.

Increased labour productivity has a similar effect to a growth in the stock of labour -- production possibilities expand. As the productivity of labour in manufacturing industries increased, the amount of labour needed to produce a given level of output decreased. While real wages were held constant, manufacturing industries reduced their employment and reduced their production costs. Thus Korean manufacturing became more competitive internationally, and exports in this sector expanded by 16 per cent (see Table V.7). Increased labour productivity also increased returns to the non-labour inputs: land and capital. This means that costs in the primary and services sectors increased, and while more labour was made available to them, increasing their outputs, both the primary product and services sectors reduced exports as they were `priced out of the international market' by rising production costs.

Table V.7: **Contributions of labour productivity improvements and import liberalisation to Korean output and export growth**
(Percentage changes)

Sector	*Productivity improvements*		*Import liberalisation*	
	Output	*Exports*	*Output*	*Exports*
Primary	3.0	-18.2	1.4	-2.3
Manufacturing	12.1	16.4	3.9	27.4
Services	6.1	-17.6	2.6	-1.0

Import liberalisation simulation

The macroeconomic effects of Korean import liberalisation are reported in Table V.5. A reduction in the tariff rate in non-food manufacturing from an average 38.2 per cent to 12.9 per cent produced a substantial increase in Korean trade and welfare. Tariff liberalisation is projected as having much larger real effects than the export enhancement policies.

These effects are reflected in the sectoral activity levels shown in Table V.7, especially in manufacturing, where exports rise by over 27 per cent. Imports account for a large part of Korean producers' costs (25 per cent of the total bill of intermediate inputs). The reduction in tariffs reduced the costs of imports to Korean manufacturers and enabled them to increase output in most industries. Exports by all industries increased, by up to 40 per cent in the apparel, and lumber and wood products industries.

Concluding comments

The simulated increases in exports and income accounted for a non-negligible portion of the changes in Korea's economic structure since the early 1960s. The simulated ratio of exports to net domestic product increased by 4 per cent with export-related subsidies, 0.07 per cent with labour productivity improvements, and over 16 per cent when imports were liberalised. This adds up to a 22 per cent change in the ratio of exports to net domestic product; that is, these factors contributed to 22 per cent of the observed change in the ratio. The actual change between 1960 and 1989, taking 1989 as the base year, was 86 per cent.

The simulations suggest that subsidised credit for exporters was successful in promoting exports from manufacturing industries. However, this did not translate into any large change in national income. A labour productivity improvement of 40 per cent resulted in projecting twice the increase in exports as the export subsidies examined. In sharp contrast to the export-related programs, the productivity improvement produced significant real income gains for the Korean economy and a significant boost to overall welfare. Import liberalisation had the most dramatic effects on export levels, increasing Korea's volume of exports by almost three times as much as in the other simulations.

However, the simulations fall short of providing a full explanation -- other factors also played a role in changing the structure of Korea's economy. During the study period, Korea's population nearly doubled and strong investment over 30 years increased its capital stock from a very low level in the immediate postwar period. This increase in the size of the Korean economy did not automatically entail an increase in the importance of exports relative to income. However, Korea's limited domestic market would favour this. Also, the particularly heavy promotion of exports through capital measures in the middle of the study period will have skewed the allocation of investment over time, with lasting additional effects on the composition of Korea's capital stock.

WEDGE also produces information on changes in the other regions it models. Impacts on the Australian economy were negligible in all three simulations. The Commission chose Korea as the subject of its modelling effort for this report because many observers have suggested it has had the most effective export enhancement measures (or at least as effective as Taiwan's, an economy which is not modelled separately in WEDGE). But the small size of the Korean economy, its relatively small economic linkages with Australia, and the concentration of its exports into goods and services not much exported from Australia combine to render changes in its trade and industry structure of little consequence to the Australian economy.

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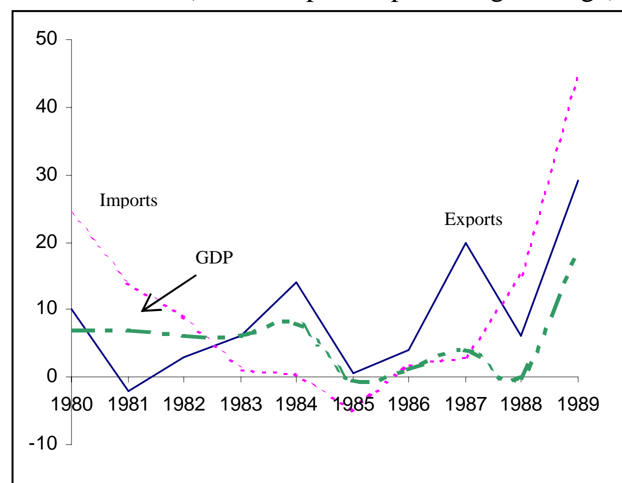
VI MALAYSIA

Since independence in 1957, Malaysia's economic growth has been consistently strong: average annual growth in real GDP was 5 per cent in the 1960s, rising to 8 per cent in the 1970s. Despite global recession in the early 1980s, followed by a collapse in commodity prices, real GDP growth over the 1980s averaged 6 per cent (Figure VI.1).

VI.1 Trade performance

Over the last decade, Malaysia has achieved strong real growth in exports -- averaging 9 per cent per year. As a result, the ratio of exports to GDP increased from 53 to 76 per cent over the period 1980-90. In the late 1980s, merchandise exports continued to grow strongly, increasing in real terms by 30 per cent in 1989 and 13 per cent in 1990. Manufactured exports have performed even more impressively, with annual real growth averaging 34 per cent between 1987 and 1989, falling back to 28 per cent in 1990. The contribution of manufactures to total exports reached nearly 60 per cent in 1990, a new record (Ministry of Finance 1990).

Figure VI:1 **Malaysia's growth in GDP and trade: 1980-89**
(Constant prices, percentage change)



Source: IMF 1990

Despite this strong growth in merchandise exports, Malaysia ran a current account deficit over most of the 1980s, largely due to its substantial trade deficit in services -- equivalent to about $A5 billion[1] per year. By 1990 external debt had reduced to 37 per cent of GNP, compared with a peak of 76 per cent in 1986.

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

The importance of agriculture to the Malaysian economy has halved in the last thirty years, from around 40 per cent of GDP in the early 1960s to 19 per cent in 1990. Reflecting this long-term decline, primary-product exports have been progressively displaced in importance by manufactured exports (Table VI.1). Now manufacturing is the leading sector, accounting for 59 per cent of total exports in 1990. The expansion in manufactured exports has been largely due to growth in the electrical machinery and appliances, textiles, and footwear sectors. Electrical and electronic goods account for over 50 per cent of total manufacturing exports.

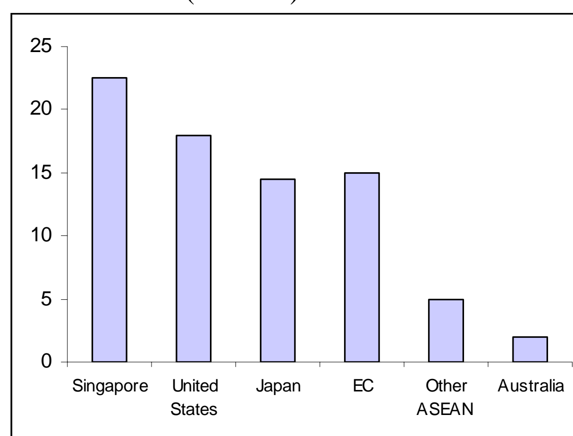
Table VI.1: **Merchandise exports from Malaysia**
(Per cent)

Sector	*1985*	*1990*
Manufactures	33	59
Crude oil	23	13
Palm oil	10	5
Sawlogs	7	5
Rubber	8	4
Liquefied natural gas	6	3
Tin	4	1
Cocoa	1	1
Other primary commodities	8	9
Total	**100**	**100**

Source: Ministrv of Finance 1991a

Major industrialised countries (ie USA, Japan, EC) are Malaysia's dominant export markets (Figure VI.2). Although Singapore is the major destination for Malaysia's exports, the goods involved are mainly destined for re-export. Other ASEAN countries account for only a small share of Malaysian exports (some 5 per cent).

Figure VI.2: **Major destinations of Malaysia's exports: 1990**
(Per cent)



Source: Malaysian Government 1991a

VI.2 Trade and industry policy

In 1963, a made-to-measure system of import tariffs[2] was introduced which, although initially involving modest levels of assistance by international standards, became progressively more protective in subsequent years. Import-substitution policies induced something of a spurt of industrial growth in the short-term, with output growing rapidly within the confines of the country's domestic market. After a decade of rapid industrialisation, however, Malaysia's small domestic market began to show signs of saturation. The eventual outcome was stagnation, with subsequent industrial growth restricted to growth in domestic demand. There was no automatic `spillover' to the export market, as policy makers had originally hoped for.

In this environment the need to emphasise manufactured exports was recognised. (Garnaut p. 282) This reassessment culminated in the *Investment Incentives Act 1968,* which replaced the Pioneer Industries Ordinance. The Act offered a wide range of incentives to industry, including tax holidays, investment tax credits, duty drawback and exemptions, and location incentives. In addition, specific incentives were offered to exporters, (eg targeted tax exemptions).

The *Promotion of Investments Act 1986* was introduced to succeed the 1968 legislation -- at the same time aligning Malaysia's tax incentive package so that the measures were competitive with inducements being offered by neighbouring economies. The incentives offered under this legislation were more attractive than earlier ones, with a strong bias towards manufacturing, agriculture and export-oriented industries generally. Industry incentives are also provided under the *Income Tax Act 1967,* Malaysia's principal tax legislation. However, it was announced in the Government's 1992 budget that some of these incentives were to be reduced.

The current focus of government policy is on expanding the role of manufacturing further, with the aim of increasing and diversifying Malaysian exports. To achieve this, the Government offers a generous system of incentives aimed at attracting foreign investment into export-oriented manufacturing industries (Box VI.1).

These incentives are available to all firms: they are not explicitly aimed at exporters. Yet, many incentives are only available to `eligible' firms, that is, those that plan on making `promoted products' or are in `promoted industries'. Nearly all products and industries on the promoted list are ones in which Malaysia sees potential for export -- for example, rubber, leather, wood, chemicals, textiles, machinery, electrical and electronic products (MIDA 1990).

It seems clear that the foreign investment regime is designed primarily to promote manufactured exports.

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[2] A made-to-measure tariff system aims to provide the minimum levels of assistance required to ensure local activity.

Box VI.1: **Malaysian investment and tax incentives**

Pioneer status -- Companies receive an `income abatement' of 70 per cent for 5 years (ie 70 per cent of assesed income is not subject to tax). The balance is taxed at the corporate rate of 35 per cent. A full exemption (100 per cent) is still available to companies investing in what are termed `strategic projects of national importance' (in practice high-technology sectors or in respect of investments involving large capital expenditures).

Investment tax allowances (ITAs) -- provide an income tax exemption equivalent to 60 per cent of qualifying capital expenditure (up to a maximum of 70 per cent of a companies annual income). ITAs are not available to companies that have enjoyed or are enjoying pioneer status in respect of a similar product or activity.

Capital Expenditure Allowances -- are available for qualifying plant expenditure in lieu of depreciation allowances. They consist of an initial allowance (generally 20 per cent) followed by an annual allowance. There are four types: reinvestment allowance; extended industrial building allowance; agriculture allowance; and forest allowance.

Double Deductions -- are aimed at encouraging businesses to participate in specific activities. Promoted activities include: export promotion; approved training in the construction and manufacturing industries; and approved research.

R&D Incentives -- The Government offers a number of measures aimed at increasing R&D expenditure to the equivalent of 2 per cent of GDP by the year 2000. These incentives include:

- tax exemption of five years to approved companies carrying out research. Dividends are also tax-exempt in the hands of shareholders, and accumulated losses can be carried forward after the tax-exempt period;

- double deduction to persons who invest in approved research institutions, and to companies which use the facilities and services of approved research companies or institutions; and

- tax exemption of 5 years for new-technology based firms.

Sources: Ministry of Finance 1991b; Price Waterhouse 1991

The organisation that oversees Malaysia's investment policies is the Malaysian Industrial Development Authority (MIDA). MIDA promotes and co-ordinates industrial development in Malaysia and advises on, among other things, investment and tariff policy. MIDA works closely with foreign investors and exporters through its many overseas offices.

MIDA's main functions are to:

- conduct economic feasibility studies of industrial possibilities;
- conduct industrial promotion work, both at home and abroad;
- evaluate applications for tax and import duty exemptions;
- recommend on and develop industrial sites;
- report on the progress and problems of industrialisation; and
- advise government on measures to protect and promote industries -- including tariffs, customs exemptions and import/export licenses.

The Government is pursuing a trade-liberalisation program with the objective of making the tariff structure more uniform and progressively reducing high levels of protection. In its Sixth Malaysian Plan, the Government stated that it will:

> ... continue to participate actively in international fora ... for the reduction and removal of tariffs and non-tariff barriers encountered by Malaysian exporters. Dialogues with ASEAN partners, will continue in order to improve market access of Malaysian products (Malaysian Government 1991b, p.228).

In its 1992 Budget, the Government reduced tariffs on a range of items. Duties fell from 30 to 20 per cent on a large range of textile and clothing products; from 50 to 30 per cent on some processed foods; and from up to 55 per cent to 2 per cent on some chemical products.

The Government's New Economic Policy (NEP) 1971-1990 document emphasised employment-creation and distributional goals. In particular, export expansion was a central element. In 1991, the NEP was replaced by the New Development Policy (NDP) which is embodied in the Sixth Malaysian Plan (SMP) 1991-1995 and the Second Outline Perspective Plan (OPP2) 1991-2000.

Economic policies under the NDP are directed towards strengthening domestic sources of growth by maintaining macroeconomic stability, promoting private sector efficiency and productivity, encouraging high levels of private investment, diversifying the industrial base and expanding exports (Low 1991). Investments in manufacturing will continue to be promoted by providing a favourable investment climate, improved infrastructure and support for domestic private sector participation and investment. Liberalisation and deregulation of the industrial sector is to continue.

OPP2 sets out a wide range of economic and social targets aimed at correcting perceived social and economic imbalances, while at the same time encouraging continued growth and structural transformation in the Malaysian economy (Box VI.2).

Box VI.2 **Aims of Malaysia's Second Outline Perspective Plan 1991-2000**

The Plan's main economic aims are to:

- achieve sustainable growth with price stability, with real annual GDP growth of 7 per cent;
- encourage the private sector to play the lead role in economic growth;
- reduce the role of the public sector in the economy;
- encourage domestic saving;
- accelerate the privatisation program to stabilise public expenditures and reduce fiscal deficits;
- diversify the structure of production in order to deepen and widen the country's industrial base;
- emphasise increasing `value added' through greater utilisation and processing of domestic natural resources;
- place greater emphasis on technological innovation and human resource development; and
- upgrade the country's infrastructure.

Source: Malaysian Government 1991a

The thrust of the SMP is to promote new sources of growth to strengthen and diversify the industrial base. Emphasis is to be placed on the development of export-oriented, high value-added, high-technology industries with strong support from domestic R&D. The objective of the SMP is to move towards capital-intensive and technologically sophisticated industries. To this end the Government is to emphasise measures to accelerate industrial restructuring, technological upgrading, human-resource development and industrial linkages.

The distinction between investment and export incentives has become increasingly blurred in the Malaysian context. The Government expresses a strong preference for foreign investment in export-oriented industries, rather than in import-competing ones. Accordingly, investment incentives offered to foreign investors form an integral part of the export development program. (Ariff and Hill 1985p. 68) The level of investment incentives, however, is declining. It appears that incentives do not need to be quite as generous as once thought; changes in the 1992 Budget (with subsequent refinements) reflect this changing attitude. For example:

- `pioneer' companies, previously exempt from paying any income tax now pay tax on 30 per cent of their statutory income. In addition, extension of the pioneer period was abolished;

- the investment tax allowance was reduced from 100 per cent to 60 per cent of qualifying expenditure, and a ceiling placed on the allowance (70 per cent of net income);

- the 5 per cent income abatement for the use of indigenous Malaysian materials is to be abolished in 1993;

- the 50 per cent export income abatement is to be phased out by 1994 for foreign firms (ie less than 70 per cent Malaysian owned); and

- the 5 per cent export allowance is to be phased out by 1994 for foreign firms.

VI.3 Export enhancement measures

Export finance assistance

Malaysian companies can turn to a number of bodies for export finance assistance. In the main, such assistance is provided by the Malaysian Export Credit Insurance Berhad (MECIB). MECIB was established in 1977 as a joint venture between the Malaysian Government and existing Malaysian commercial banks and insurance companies. In 1988, however, MECIB was acquired by Bank Industri Malaysia Berhad, a development financing institution wholly owned by the Malaysian Government.

MECIB's principal objective is to complement and supplement the country's export-promotion efforts by providing a range of export credit, insurance, and guarantee facilities. These include:

- comprehensive short-term insurance policies (covering both commercial and political risks for a term of less than six months);

- confirming bank insurance policies (covering banks which provide irrevocable letters of credit);

- specific insurance policies (covering exports of capital goods and associated services);

- bond indemnity support facilities (covering commercial banks which issue bonds on behalf of Malaysian exporters); and

- bankers export finance insurance policies (covering financial institutions which provide pre- and post-shipment loans to exporters) (MIDA 1990).

The activities of MECIB are subsidised in a number of ways. First, paid-in capital is provided through a grant by the Government (and this was increased by $M60 million ($A28m) in 1990). Second, MECIB is able to borrow at below market rates from its holding company BIMB to cover any shortfalls. In 1990, a loan of $M10 million ($A4.7m) was extended, repayable over 10 years at an annual interest rate of 1 per cent (MECIB 1991). Although in 1990 MECIB showed a $M3.4 million ($A1.6m) loss on its underwriting account, government support enables it to show an `accounting' profit on its balance sheet.

Malaysia's central bank (Bank Negara) manages an export credit refinancing scheme (ECR) which provides exporters with credit at preferential rates of interest -- currently 4 per cent per annum -- to enable them to compete more effectively in international markets and break into non-traditional markets. A review of the ECR in the mid-1980s saw it expanded and strengthened. Initially this involved an extension of product coverage, liberalisation of the threshold limit and simplification of administrative procedures. In 1989, the pre-shipment facility was reorganised to assist production of exports and promote domestic backward linkages (Malaysian Government 1991b).

The main features of the scheme are:

- It is operated by the commercial banks with Bank Negara refinancing those that extend credit to eligible exporters.
- Two facilities are available:
    - pre-shipment credit for up to four months, for up to 80 per cent of the export order; and
    - post-shipment credit for up to six months of 100 per cent of the invoice value of an export.
- To be eligible, goods to be exported must have a minimum value added of 20 per cent and a minimum domestic content of 30 per cent.
- The minimum amount of ECR financing is $M10 000 ($A4730). The maximum amount of refinancing for each exporter is limited to $M5 million ($A2.4m), but higher limits may be granted upon application to Bank Negara (Ernst & Whinney 1991p. 30).

In 1990, a new Export Credit and Insurance and Guarantee scheme was introduced to complement the ECR scheme: the Banker's Export Finance Insurance Policy is designed to protect commercial banks and financial institutions against non-payment of loans and advances made to exporters and suppliers.

Export marketing assistance

The Government has allocated $M137 million ($A65m) to trade promotion over the five-year period of the Sixth Malaysian Plan to expand manufactured exports through improvements in marketing and information networks. A new organisation, the Malaysian Export Promotion Bureau (MEPB) is to be established to replace agencies currently involved in export promotion. MEPB will have a market-driven approach directed at consolidating and co-ordinating export promotion activities. Centres will also be established abroad in a rationalisation of existing overseas trade representation (Malaysian Government 1991b).

A number of government bodies are currently involved in export promotion and trade facilitation.

- The Malaysian Export Trade Centre (MEXPO) provides product-promotion assistance to exporters. Exporters can display their products to visiting trade missions and buyers at MEXPO's Kuala Lumpur premises.

- The Export Promotion Council was established in 1987 to enhance export growth. The Council serves as a forum to discuss and resolve problems affecting the export sector.

- The National Facilitation Trade Committee examines procedures, formalities and paperwork relating to trade transactions. The Committee has simplified exchange controls, and reduced and standardised trade documentation.

Tax incentives are also available to assist firms in their trade-promotion and marketing activities. A double deduction is available for expenditure on export promotion and marketing. In the 1991 budget, this incentive was extended from applying solely to manufacturers to cover also tour and hotel operators, and international trade fairs held locally.

Trade-related investment measures

No local equity conditions are imposed on companies that export at least 80 per cent of their output. Companies exporting between 50 and 80 per cent of their output can be 100 per cent foreign-owned if they have invested at least $M50 million ($A24m) or the output has at least 50 per cent local value added.

Export processing zones

EPZs have been established in the States of Penang, Selangor, Johor and Melaka. These are areas specifically designed for manufacturing establishments producing or assembling products for export. EPZ facilities enable export-oriented companies to enjoy duty-free access and minimum customs control and formalities when importing raw materials, parts, machinery and equipment.

Companies which export at least 80 per cent of their product and have to import raw materials and components may locate in an EPZ. Goods sold by EPZ companies into Malaysia for domestic consumption are subject to the same duties as are applicable to foreign imports.

EPZ firms can make use of the investment incentives offered to manufacturers outlined under the *Promotion of Investments Act 1986* and the *Income Tax Act 1967* (and changes introduced in the 1992 Budget). Where the establishment of an EPZ is neither practical nor desirable, the Government allows Licensed Manufacturing Warehouses (LMWs). Their aim is to encourage the regional dispersal of industries, as well as manufactured exports. Accorded similar facilities to EPZ firms, LMWs must meet the same criteria -- that is, at least 80 per cent of output is exported and/or inputs need to be imported. (Price Waterhouse - Malaysia 1990p.37)

Other tax incentives

Malaysia has been perhaps the largest user in the region of tax exemptions and incentives directed at encouraging exports. Were it not a developing country, many of these schemes could be challenged under the GATT.

Resident companies in Malaysia are subject to income tax at a flat rate of 35 per cent on their net profits, whether distributed or not. At present, business activities (carried out by firms or individuals) are liable for a Development Tax of 3 per cent. However, this is being phased out -- reducing to 2 per cent in 1992 and zero in 1993.

In addition to `pioneer status' and the other incentives (see Box VI.1 p. 74), a 50 per cent tax exemption on export income is extended to `eligible' companies exporting directly or through agents, to encourage them to export locally manufactured products. Exports include the transfer of local products to companies located within customs-free areas (ie EPZs and LMWs).

A tax exemption of 5 per cent of the value of indigenous Malaysian materials incorporated into exports also applies, but is to be abolished in 1993.

Tax-exempt profits can be distributed to shareholders as tax-exempt dividends. If the exemption exceeds profits in any year, the excess can be carried forward against future profits.

The Government announced that the export income exemption scheme will be phased out for foreign firms (ie those with less than 70 per cent Malaysian ownership), reducing to 25 per cent in 1993 and zero in 1994. This change also applies to firms located in EPZs.

Companies exporting agricultural or manufactured products are eligible for an export allowance of 5 per cent of the fob value of export sales. The export allowance is deductible from a company's gross income for tax purposes. This scheme is also being phased out, reducing to 3 per cent in 1993 and to zero in 1994.

A double deduction for export credit insurance premiums paid to MECIB or other approved insurance companies (MIDA 1991P. 15) is offered to encourage exporters to sell into non-traditional markets.

As an incentive to Malaysian construction companies to venture abroad, half the profits from a project outside Malaysia which commences between 21 October 1988 and 31 December 1993 are exempt from tax if they are remitted to Malaysia within five years after the project's commencement date. (Price Waterhouse - Malaysia 1990p.34)

Under the *Tax Act 1967*, depreciation of fixed assets is not allowed for tax purposes. Instead, capital allowances are granted at specified rates for certain types of assets. These provide for an initial and an annual allowance. For example, companies are eligible for the Industrial Building Allowance (IBA) for buildings used as warehouses or bulk storage installations for exports. The IBA consists of an initial allowance of 10 per cent and an annual allowance of 2 per cent.

An Investment Tax Allowance (ITA) is available for up to 60 per cent of capital expenditure incurred on `promoted' products or activities. The allowance is based on a percentage of qualifying expenditure undertaken, and is available for five years. In any one year, the maximum allowance available is limited to 70 per cent of net income. Any unused allowance can be carried forward until fully utilised. The approved expenditure is determined by a number of criteria -- one of which is the level of export and proportion of value added.

In addition to the general incentives available to all industries, approved tour operators who bring in at least 500 foreign tourists through (group-inclusive) tours are exempt from income tax. This incentive is scheduled to cease in 1993.

Other measures that indirectly enhance exports

The following measures are either directed at firms producing mainly for the local market (but also for export) or are aimed at neutralising the anti-export bias created by protective measures. For the purposes of this inquiry, they have not been regarded as export enhancement measures. However, the indirect assistance they extend to exporters makes them worth mentioning in order to give a more complete picture of the environment in which Malaysian exporters operate.

A 20 per cent discount on electricity rates is available for industry, making electricity prices in Malaysia one of the lowest in Asia (Todd 1987). Although not directed only at exporters, this concession lowers costs and enhances international competitiveness.

Companies manufacturing finished products for the export market are normally granted full exemption from customs duties on imported raw materials, provided such materials/components of acceptable quality and price are not manufactured locally. (Price Waterhouse - Malaysia 1990).p.34 Almost all imported machinery and equipment directly used in manufacturing is exempt from import duty and sales tax. (Price Waterhouse - Malaysia 1990)p.35 In addition, all duty-paid goods used as inputs in the manufacture of other goods that are subsequently exported are eligible for drawback of duty in full. However, export must be within 12 months of the date on which customs duties are paid. Packaging materials are not eligible for drawback (Price Waterhouse 1990).p.35

VI.4 Economic effects of export enhancement measures

Effects on the Malaysian economy

It is difficult to know to what extent Malaysia's economic success is attributable to the Government's general trade and industry policies, let alone how effective specific export enhancement measures have been. Very little formal analysis is publicly available about Malaysia's post war economic growth. Nevertheless, this section reviews available evidence.

In a survey of Malaysian manufacturing exporters, Ariff and Hill (1985) found that some companies which were eligible for export incentives did not avail themselves of such incentives, either because of lack of knowledge about them or cumbersome administrative procedures. They did not find any strong association between export performance and export incentives. At best, export incentives only partially assisted in correcting or neutralising the existing anti-export bias caused by protection.

While it was possible to attribute the start of individual projects to specific incentives, what appears to have been much more important for Malaysia's industrial success was that the Government created a general climate of stability and economic flexibility, and was generally supportive of private initiative and enterprise -- a policy which is to the fore in the new OPP2 (see Box VI.2, p.76).

Initially, export expansion was through foreign investment and international subcontracting arrangements, particularly in the EPZs. A census of firms located in EPZs in 1978 revealed that about 94 per cent were foreign-controlled (Linnemann *et al* 1987). Between 1973 and 1976, manufactured exports increased from the equivalent of $A1.2 billion to $A2.1 billion. At least 70 per cent of this increase has been attributed to international subcontracting arrangements where labour-intensive processes were transferred to Malaysia (Lee 1981).

A cost-benefit analysis carried out by Warr (1987) suggested that there has been a net gain to Malaysia from the operations of EPZs. The benefits from employment, use of domestic raw materials and capital equipment, purchase of electricity, payment of taxes, and foreign exchange

earnings were found to be more than sufficient to outweigh the costs incurred in establishing, maintaining and administering the zones. EPZs have mainly contributed to Malaysia's economic success through their absorption of unskilled and semi-skilled labour into the workforce.

In the early 1980s, over half Malaysia's total exports of manufactured goods came out of EPZs. In few other economies has their role been as significant, either in absolute terms or as a proportion of overall manufacturing activity.

However, it has been argued that companies in the EPZs tend to have only minimal links with local industry outside the zones (Todd 1987). One example is microchip manufacturers which led the surge in exports during the late 1980s. The electronic companies involved, all foreign-owned multinationals, are classic `screwdriver' industries -- importing almost all of their raw materials and machinery and equipment, whilst exporting little in the way of value added.

According to Linnemann et al (1987, pp.373-6):

> ... the typical electronics assembly plant located in one of the [EPZs] imports about 60 per cent of its total intermediate input requirement. The remaining 40 per cent is mainly spent on electricity purchases and some other domestic inputs of negligible value ... export expansion in Malaysia is a concern for only a few industries, mainly located in the EPZs, leaving the rest of the manufacturing sector unaffected.
>
> The pursuit of a dualistic industrial strategy in Malaysia, leading to an export sector largely situated in EPZs, and standing apart from the usual import-substitution sector ... thwarts a systematic specialisation in labour-intensive manufactures for export production.

In Malaysia, the proportion of total raw materials purchased locally by EPZ companies is usually small, and has in the past often been lower than the proportion purchased from other companies within the EPZs themselves (Warr 1987).

Much of the early increase in Malaysian exports was traceable to the location by multinational corporations (MNCs) of minor, separable labour-intensive parts of larger production processes within EPZs (Lee 1981). (Lee 1981)p.18 EPZ development is essentially offshore in nature, has limited linkages to the domestic economy, and makes only a modest contribution to long-term development goals. It appears that EPZs are most successful where, as in Korea, they are an element of a broader export-development strategy, rather than a substitute for such a strategy, as was , in effect, the case in Malaysia (Bhattacharya and Linn 1988 p. 95).

In the five years to 1987, the Government provided substantial assistance to heavy industry, convinced that huge capital-intensive plants would lead to the creation of smaller industrial suppliers. But the economy went into recession as some of these projects (ie a steel rolling mill) came on stream. Others, like cement plants and the processing of gas into chemicals, were hit by the collapse in oil prices and a slump in construction. Exporting was not an option for most of these plants, since the production costs of cement and steel exceed world prices. Private sector business people, led by the Federation of Malaysian Manufacturers, complained that the intrusion of favoured government enterprises in all sectors had crowded out private investment (Todd 1987).

The proliferation of tax incentives in Malaysia has, in part, been a response to those provided by other competitor economies in the region. In the past, a widespread feeling existed that, to compete with others vying for investment, Malaysia had to match incentives which were on offer elsewhere. Current thinking, however, is that existing incentives may be better used on a more selective basis, that is, to target particular activities. According to the Sixth Malaysian Plan:

> Efforts will be made to monitor and assess the benefits of granting the various investment incentives with a view to putting a more selective and effective system for granting of incentives ... Incentives will be aimed at enhancing self-reliance ... The list of promoted products and activities will be reviewed so as to be more selective in the award of incentives, especially to the well established import-substituting industries ... [there will be] more emphasis on non-tax incentives which include, among others, the provision of better quality infrastructural and other support facilities (Malaysian Government 1991b, p.140).

Table VI.2: **Reasons for locating in Malaysia: 1990**
(Ranking)

	Size of business unit		
Reason	*Small*	*Medium*	*Large*
Political stability	1	1	1
Economic stability	2	2	2
Availability of labour	3	3	3
Good communication systems	5	4	6
Tax incentives	6	6	4
Competitive cost advantage	8	5	5
Availability of raw materials	4	9	7
High quality labour	9	7	9
Geographic location	10	8	8
Presence of supporting industries	7	11	11
Liberal exchange controls	11	10	10
Others	12	12	12

Source: Federation of Malaysian Manufacturers 1990

The idea that tax incentives may not be as important in location decisions -- as was previously thought -- is backed up by a recent survey carried out by the Federation of Malaysian Manufacturers (Table VI.2). Although tax incentives appear to be more important to large firms than to small- and medium-sized ones, such incentives are well down the list for all firms, and not considered as important as political and economic stability, availability of labour, competitive cost advantage, or the quality of the communication network.

The change in attitude towards the importance of tax incentives was reflected in the 1992 Budget Speech:

> Investors do not only look at fiscal incentives but also political stability, the availability of trained and disciplined manpower and other non-fiscal incentives (Malaysian Government 1991c, p.16).

Treasury Secretary-General Datuk Mohd Sheriff Kassim recently commented:

> Investors do not only look at generous tax holidays as a primary reason for investing in a country as there are more important factors such as political stability, administrative efficiency, liberal rules and regulations on investment and a good infrastructure system to consider (cited in Lim 1991, p.14).

Effects on the Australian economy

Some of the export enhancement measures used by Malaysia have had a negative but small effect on some Australian industries by lowering the costs of Malaysian exporters and giving them a competitive edge over Australian companies in Australia and in third-country markets. The Commission has obtained some examples of this effect, although it is limited and in one case (batteries) the impact has been negligible. These cases are outlined below.

Malaysian export enhancement measures have recently been the subject of a complaint to the *Australian Customs Service under the Customs Tariff (Anti-Dumping) Act 1975*, and, on appeal, to the Anti-Dumping Authority. The application, by GNB Australia, alleged that government subsidies to, and dumping by, Malaysian battery manufacturers were adversely affecting Australian suppliers in their home market, leading to losses in market share and profits. The Customs report (ACS 1990, p.59) found that:

> ... the export credit refinancing and abatement of adjusted income for exports schemes fall within the meaning of subsections 269TJ(1) and (2) and are subsidies broadly fitting into the illustrative list of export subsidies in the Annex of the Subsidies Code [the GATT Code on Subsidies and Countervailing Duties].

The case argued by GNB was given added credence by remarks made by the then Chairman of the Battery Manufacturers' Association of Malaysia, at the 2nd Asian Battery Conference in Singapore in 1987:

> In addition, [to duty drawbacks and export credit refinancing], there is a wide number of new incentives covering specific situations -- all for the purpose of encouraging Malaysian Battery manufacturers to export their products. These facilities therefore, enable the Malaysian battery manufacturers to compete in certain export markets (Rahman 1987, p.5).

Although Customs concluded that no material injury had been caused by dumping or subsidisation, a review of the Customs report by the Anti-Dumping Authority (1991) overturned the decision in

relation to dumping, but upheld the finding that no injury was caused by the subsidisation. No injury was found, and hence no countervailing action flowed from this case. Although subsidisation was proved, it was considered that the level of subsidy -- about 15 cents (or 0.4 per cent) per battery -- was too small to cause any material injury to Australian manufacturers.

As described in section VI.2, various incentives exist for firms investing in `promoted activities and promoted products'. Among the numerous activities and goods listed are the `manufacture of leather (tanning) and leather products'. In a submission from the Federated Tanners' Association of Australia (FTAA), Malaysia was identified as one of several countries with export subsidies that had a negative impact on Australia's ability to export tanning products into Malaysia and third markets.

The FTAA (Sub. 13, p.28) stated that:

> ... the domestic and export subsidy practices of foreign governments and non-tariff barriers in force in many countries are very real obstacles to further development of an important Australian industry, one that is uniquely placed to make better utilisation of a valuable and naturally recurring resource, and so enhance its already significant export performance -- with consequent assurance of the continued economic viability of the industry.

According to two case studies of FTAA members, Malaysian export subsidies had contributed to the `loss of sales and profits.'

VI.5 Concluding comments

Malaysia's export success is often used as an example by proponents of export enhancement of what Australia could achieve if it followed a similar strategy. Faced with evidence of export incentives and successful export growth, it is tempting to draw a causal link between the two and to argue that other countries should follow their approach.

It is inappropriate to apply the experiences of a developing country like Malaysia to all countries, and developed countries in particular. To a large extent Malaysia's strong growth has occurred because the country is going through a `catch-up' stage of development. More significantly, Malaysia's export incentives have to be seen in the context of the Government's overall industrialisation strategy -- where political stability and a pro-business environment are considered fundamental (as emphasised by the Malaysian Minister of Finance in his 1992 Budget Speech). Export incentives in Malaysia make up only a small part of an overall package of measures designed to attract investment in export-oriented manufacturing.

Although the nominal value of manufactured exports has risen significantly over the last two decades, the growth in local value added contained in these exports is less spectacular. Much of Malaysia's growth has come from foreign firms located in its many EPZs. They consist in large part of MNCs which have moved low-technology, labour-intensive manufacturing processes into

Asia in pursuit of low wages. A significant proportion of the raw materials, capital goods and intermediate inputs are imported -- so backward linkages to domestic suppliers have been limited. Technology transfer has been relatively small, and tax incentives are so generous that many foreign companies pay virtually no tax. Value added is still relatively low and a large part is made up by wages. The situation, in terms of the activities of MNCs, is not significantly different outside the zones.

The generous tax incentives have partly developed from a perception that Malaysia had to match the incentives being offered by its neighbours to attract investment. However, this attitude is changing and some reduction in the generosity of incentives was introduced in the 1992 Budget. Experience has shown that firms do not leave as soon as the incentive period runs out, making the government wonder whether it needed such generous incentives in the first place. Announcing the changes, the Malaysian Ministry of Finance (1991a, p.13) said:

> Too many incentives given continuously will pamper and reduce the efficiency of companies and will not enable them to become competitive.

In other areas -- trade liberalisation, reduction of the public sector's role in the economy and greater emphasis on education, training and R&D -- Malaysia is moving in the same direction as other countries in the region.

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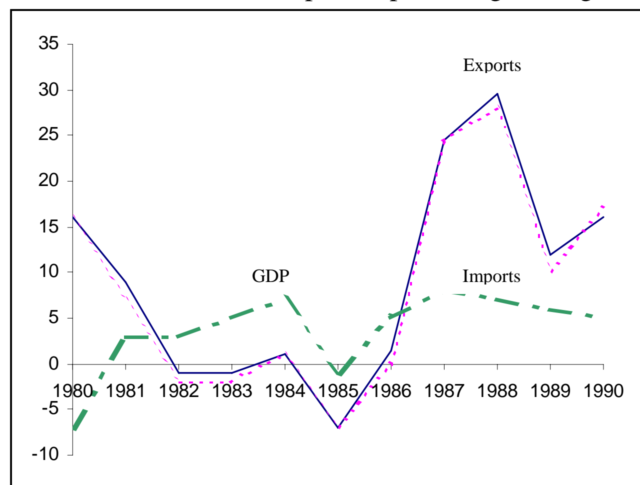
VII SINGAPORE

Since attaining self-government in 1959, Singapore -- an island city-state of only 626 square kilometres with a population of less than 3 million -- has recorded remarkable economic growth. Singapore's real GDP over the period 1960-90 has increased at an average annual rate of 8.4 per cent. Sustained high rates of GDP growth have meant that Singapore has one of the *highest per capita* incomes in Asia and virtually no unemployment.

VII.1 Trade performance

International trade underpins Singapore's strong economic performance. Between 1980 and 1990, Singapore's exports grew at an average annual rate of 8.7 per cent from $S35 billion ($A30.8b)[1] to $S95 billion ($A67.1b). Re-exports make up one-third of total exports. Singapore currently ranks 18th and 15th respectively among world exporters and importers. Its share in world merchandise exports was 1.5 per cent in 1990.

Figure VII:1 **Singapore's growth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: IMF 1990

Singapore runs a persistent merchandise trade deficit because of the significance of imported intermediate goods for Singapore's exports, along with its reliance on imported food products and capital goods imports. However, this deficit has been more than offset by earnings from the services sector and by the inflow of capital. Figure VII.1 highlights Singapore's GDP and trade growth since 1980.

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

Singapore's export mix has changed significantly over the past decade. In 1980, 56 per cent of Singapore's domestic exports comprised mineral fuels. By 1990, this proportion had declined to 28 per cent. On the other hand, machinery and equipment's share in domestic exports increased from 25 per cent to 52 per cent over the same period. Table VII.1 shows the changing composition of Singapore's domestic exports.

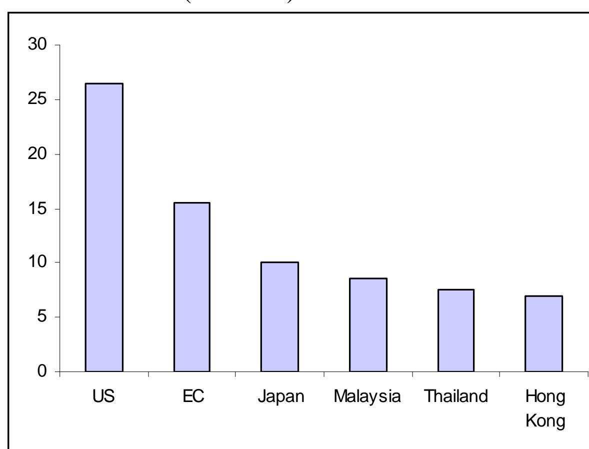
Table VII.1: **Singapore's domestic exports: 1980-90**
(Per cent)

Item	*1980*	*1990*
Mineral fuels	56	28
Chemicals	2	6
Machinery and equipment	25	52
Other merchandise	17	14
Total Domestic Exports	100	100

Source: GATT 1991, p.21

Over half of Singapore's domestic exports are destined for the industrialised countries (the United States, the EC, and Japan), with around 28 per cent going to the other Asean countries. The main re-export markets were Malaysia, the EC and the United States. Singapore's major domestic export destinations are indicated in Figure VII.2.

Figure VII.2: **Major destinations of Singapore's domestic exports: 1990**
(Per cent)



Source: GATT 1991, p.24

VII.2 Trade and industry policy

In the 1950s Singapore was essentially an entrepôt port with a free trade policy -- an intermediary in the trade between Europe and South-East Asia. Singapore had some important assets -- a world-class port and a tradition of trading. At the time of self-government, facing serious employment problems and declining entrepôt trade, the Singapore Government embarked on a policy of industrialisation to expand the base of the economy.

At first, an import-substitution strategy was adopted and moderately protective tariffs were introduced. However, largely because of changing regional alliances, this approach was abandoned and by 1967 the Government was vigorously pursuing export-oriented industrialisation. Foreign investment was to play a key role in the Government's strategy. Linnemann *et al* (1987, p.383) note that:

> The government's approach to making Singapore attractive to foreign investors encompassed from the outset three major fields: (1) creation of industrial institutions and the development of industrial estates; (2) provision of tax incentives, financial assistance schemes and specific export incentives; and (3) accelerated manpower development and enforcement of industrial discipline.

To strengthen its institutional support framework the Government expanded the Economic Development Board as a `one-stop' investment centre to promote export-oriented foreign investment. It set up the Development Bank of Singapore, the Jurong Town Corporation, the Singapore Institute for Standards and Industrial Research and the National Productivity Board to facilitate the industrialisation process.

Investment and export incentives were targeted to attract export-oriented foreign investment. Existing tax investment incentives were boosted and a host of new incentives introduced. Incentives to encourage firms to increase exports remained limited, as the Government relied largely on foreign investment for this purpose. The Government's strategy also involved intervention in the labour market, with political control imposed on unions and changes to the education system to promote skill development. Most tariffs were dismantled and quota restrictions removed.

The effect of these measures was to bring about rapid growth in foreign investment, manufacturing production, and exports. Over a decade, the dependence of the economy on entrepôt trade was cut back as labour-intensive, low-wage, export-oriented manufacturing expanded.

The slow-down in the Singapore economy which followed the `export recession' of 1974-75 prompted the Government to boost export assistance. Capital subsidies were provided for financing exports and for capital expansion; the Monetary Authority of Singapore opened a rediscount facility to banks eligible for export and pre-export insurance bills; and, in 1976, the Export Credit Insurance Corporation of Singapore (ECICS) was formed. In addition, concessional financing was provided to the shipbuilding and ship-repair industry.

The 1979 10-year `Economic Development Plan for the Eighties' heralded Singapore's second phase of export-oriented industrialisation. The Plan aimed at restructuring the manufacturing sector towards more technologically sophisticated, smaller-scale, skill-intensive and higher value-added and export-oriented production. To manage labour-supply constraints, a three-year `corrective' wage policy was introduced to discourage labour use in favour of capital-intensive production processes. Research and development (R&D) and skill-development incentives were introduced to facilitate restructuring.

The world-wide recession of 1985-86 underscored Singapore's vulnerability to fluctuations in international trade, prompting a review of the Plan by the Ministry of Trade and Industry's Economic Committee. The Committee (1986) highlighted the need to diversify Singapore's export base and called for an aggressive expansion of investment and export incentives. For Singapore to remain competitive, it argued, it was necessary to match the incentives offered by competing countries (for example Korea's R&D incentives).

The recession also inspired a fundamental rethink of Singapore's policy direction. The EDB's (1988) `Gearing Up for an Enhanced Role in the Global Economy' outlined the Government's strategy for Singapore to attain developed-nation status in the 1990s. The strategy involves: promoting Singapore's superior infrastructure and high standard of professional and technical skills; improving the value added and competitiveness of industry; and `networking' the operations of Singaporean firms with activities in other countries.

Recent policy in Singapore has focussed on the concept of a `greater Singapore economy'. The city-state would become the focus of a sphere of economic influence built on export processing zones located in neighbouring countries. The Government is encouraging companies to locate their headquarters in Singapore, but to produce elsewhere -- particularly if competitive production relies on low-cost labour. One manifestation of this is the Growth Triangle which links the southern Malaysian State of Johor with Singapore and Indonesia's neighbouring Riau Islands. The first manufactured products have appeared from factories set up on one of these islands, Batam, located 20 km south-east of Singapore.

In sum, Singapore in the 1990s is continuing along its interventionist path, with the Government playing a key role in the economy. Export-enhancing measures remain a feature of Singapore's trade and industry policy.

VII.3 Export enhancement measures

Export marketing assistance

The Singapore Trade Development Board (TDB) is the national trade promotion agency and operates through a network of 25 overseas offices in 19 countries. Its functions are to promote exports and develop new markets for goods and services, to develop Singapore as an international trading centre, to safeguard Singapore's external trade interests and to administer Singapore's trading system.

The TDB's operating income in 1989-90 was around $S84 million ($A59m), most of which was generated from trade-administration fees (eg import quota fees and export charges). The Board spent $S4.3 million ($A3m) on trade fairs, missions and other promotional activities (TDB 1990).

Business Development Scheme

This scheme reimburses small-and medium-sized enterprises (SMEs) for expenses incurred in developing export markets. The grants cover up to 50 per cent of the cost of overseas trips and of acquiring market intelligence, and 70 per cent of the cost of participating in business-development seminars. Over the period 1986-89, the EDB paid out $S0.4 million ($A0.3m) in assistance under the scheme.

Market Development Assistance Scheme (MDAS)

MDAS cash grants cover 50 per cent of the expenses incurred by new exporters in activities such as: setting up overseas-marketing offices; improving product and package designs; overseas trips; participating in trade fairs and missions; producing promotional brochures; and bidding for overseas contracts.

In 1989-90, the TDB paid out $S3.6 million ($A2.5m) under the scheme. Grants are given on a project basis for a one- or two-year period, with individual projects eligible for up to $S250 000 ($A175 000) in assistance.

Export finance assistance

Singapore's export credit assistance system operates through the Monetary Authority of Singapore (MAS) while export insurance is provided through ECICS and the EDB.

Export credit

The MAS Rediscounting Scheme provides access to short-term financing for exporters of eligible locally manufactured export products. The interest rate charged to banks for rediscounting bills is

set by the Authority and is comparable with the discount rate on commercial bills in the interbank market. Under the scheme, banks are not allowed to charge a commission of more than 1.5 per cent above the rediscount rate charged by the Authority. The concessional rate of interest payable to the Authority by the negotiating bank is passed on to the exporter (MAS 1990).

Export insurance

ECICS is a joint (50:50) enterprise between the Government and the private sector. It provides insurance facilities to exporters for non-payment of credits relating to Singapore's exports, entrepôt trade, and associated services. It is the only provider of such services in Singapore.

In 1990, nearly all of ECICS' credit insurance was under the Comprehensive Policy which covers exporters engaged in export and re-export of goods and services which are repetitive in nature and where credits are normally for periods of less than six months. Other ECICS services (such as long-term cover for exports of capital and semi-capital goods and services, the banker's guarantee scheme, the bond issue support facility and pre-shipment credit guarantees) are largely unused by exporters (ECICS 1990).

In 1990, ECICS insured exports to the value of $S409 million (A$289m) -- less than 0.5 per cent of Singapore's total exports. The insurance relates mainly to exports to the United States, Malaysia, Australia, the UK and Hong Kong (ECICS 1990).

The Commission understands that ECICS' private sector partners have been disenchanted by its overall financial situation in recent years and as a result it may become a wholly government-owned organisation.

Export credit is also provided to SMEs through the export factoring facility of EBD's Small Industries Finance Scheme. Exporting firms assign their invoices, on a commission basis, to a factoring agency (such as ECICs) in return for a 100 per cent credit guarantee. This removes the risk of bad debts and provides for a guaranteed payment period. By advancing up to 90 per cent of the value of invoices factored on receipt of the invoices, exporters can access further funds at a subsidised rate of interest.

Tax incentives

Singapore's general tax rate for companies is 31 per cent (reducing to 30 per cent in 1992-93) and personal tax rates range from 3.5 to 33 per cent. A full imputation system is adopted in taxing corporate profits so that, to the extent that a company has paid income tax on its profits, that tax benefit can be passed as franked dividends to shareholders. Singapore's finance Minister, Dr Hu, announced in his recent Budget speech that a White Paper on a comprehensive Goods and Services Tax, as well as enabling draft legislation, was likely to be tabled in Parliament later in 1992.

The cost of most plant and machinery can be written off over an accelerated period of three years, with one-third of the cost written off each year. In addition, a full write-off is available in the year of acquisition for expenditure incurred on computers, certain office or factory automation equipment, industrial robots, expenditure on automated machining equipment, guided vehicles, and various testing equipment.

Singapore provides a wide variety of taxation incentive schemes (Table VII.2). Eligibility for taxation assistance (and for investment incentives) is not automatic. The Government is highly selective in granting assistance in order to promote industries consistent with its overall development strategy.

Table VII.2: **Singapore's taxation incentive schemes**

Scheme	*Administering Agency*
Approved International Trader	TDB
Approved Oil Trader	TDB
Double Deduction Taxation	TDB
Expansion Incentive	EDB
Export of Services Incentive	EDB
Operational Headquarters Incentive	EDB
Pioneer and Post Pioneer Industry Incentives	EDB
Pioneer Status for Countertrade	TDB
Research and Development	EDB
Singapore registered ships Incentive	EDB
Venture Capital Incentives	EDB
Warehousing and Servicing Incentive	EDB

Sources: EDB 1990, TDB 1990

Approved International Trader Scheme

Since 1990, this scheme has promoted Singapore as a global entrepôt and international trading centre. Entrepôt trade represents about 35 per cent of Singapore's total trade. The scheme provides a concessional 10 per cent tax rate, for a renewable period of five years, to income derived off-shore from trade in commodities such as agriculture and bulk edible goods, industrial goods, minerals, building materials and machinery components.

Approved Oil Trader Scheme

Singapore, the world's third-largest oil-refining centre, promotes oil trading through a concessional 10 per cent tax rate on income earned from oil trading for a renewable period of five years.

Double Deduction Taxation Schemes

Exporters can deduct against their taxable income twice the eligible expenses incurred in the following activities:

- participation in trade fairs and trade missions;
- setting up overseas trade offices; and,
- export market development, including market surveys, advertising and promotional campaigns.

Expansion Incentive

This incentive is available to eligible manufacturing and service activities and provides for up to a five year tax-exemption on profits in excess of the pre-exemption level. Firms are required to undertake a minimum investment of $S10 million ($A7.1m) in new productive equipment and machinery.

Export of Services Incentive Scheme

Singaporean companies are eligible for a five-year exemption from tax on 90 percent of export earnings from services provided to off-shore customers. The assistance is available to a wide range of service activities. To qualify for assistance, firms must be export-oriented -- with a minimum 20 per cent of its revenues derived from off-shore earnings throughout the duration of the incentive.

Operational Headquarters (OHQ) Incentive Scheme

This scheme encourages companies to set up their operational headquarters in Singapore to provide technical or other support services to affiliates located outside Singapore. Income derived from OHQ services is taxed at 10 per cent (rather than the standard tax rate) for a period of five to ten years.

Pioneer and post-pioneer industry incentives

Firms advancing technology beyond existing industry levels are eligible for `pioneer' status which provides an exemption from tax on profits from pioneer activity for a period of between five and ten years. Post-pioneer status provides for a corporate tax rate of 15 per cent for up to 5 years upon expiry of pioneer or export incentives.

Pioneer status scheme for countertrade

To encourage the development of Singapore as a centre for countertrade services, a full exemption from tax on profits arising from countertrade activity is available for a renewable period of five years.

Research and development

Taxation assistance is available to companies engaged in R&D activity through the following provisions:

- double deduction on R&D expenditure (other than on buildings and equipment);
- accelerated depreciation over three years for all R&D-related plant and machinery;
- investment allowance of up to 50 per cent of capital investment in R&D;
- extension of the initial allowance of 25 per cent and annual allowance of 3 per cent (presently available only to industrial buildings and structures) to R&D buildings; and
- capitalisation and write-off over a period of five years in respect of lump-sum payments for manufacturing know-how and patent rights.

The assistance is available to local and foreign companies (ie there are no local ownership requirements).

Singapore-registered ship incentive

To foster the growth of Singapore's shipping industry, profits derived by shipping enterprises from Singapore-registered ships are exempt from tax.

Venture capital incentives

To assist Singaporean firms gain access to export markets and new technology, a $S100 million ($A70m) Venture Capital Fund was established in 1985. The incentive allows any loss arising from the sale of shares in an approved venture company to be fully deducted against the investor's other income.

Warehousing and servicing incentive

Firms using Singapore as a base for international trading and warehousing are eligible for a 50 per cent tax exemption on `approved' export earnings for a five year period.

Export processing zones, industrial estates and infrastructure

Singapore has been described as one big export processing zone. From the outset, industrial estates have been a feature of Singapore's development strategy. The Jurong Town Corporation (JTC) is responsible for the overall planning and management of 29 industrial estates owned by the Corporation. These estates accommodate some 4ÿ500 firms which account for over three-quarters of Singapore's total manufacturing employment. Most industrial estate tenants are export-oriented foreign firms -- the high tenancy rate is an outcome of Singapore's laws which prohibit foreign firms from owning land.

In 1990, the Corporation's fixed assets were valued at $S2.4 billion ($A1.7b) (JTC 1990). The Commission understands that the JTC is expected only to break even in its operations, rather than achieve a particular rate of return. This means there are large subsidies involved in its operations. The development and maintenance of harbour and related port facilities has been a critical factor in Singapore's export success.

Trade-related investment measures

The Export of Services Incentive Scheme involves an export performance requirement as a condition of eligibility for the taxation concession. Guisinger (1986) also claimed the Singapore Government, through the EDB, imposes implicit export requirements on investment, that is, only projects which meet trade-performance criteria are eligible for incentives.

Research and development

The Commission has no information on the possible extent to which R&D funds in Singapore are targeted towards exports. However, given the export-oriented nature of much of its industry, R&D expenditure and exports are inevitably linked.

Apart from the taxation concessions discussed above, the principal channel for encouraging private R&D in Singapore is through the Science Council of Singapore's (SCS's) R&D Assistance Scheme (RDAS). Grants are available to cover from 30 to 70 per cent of direct project costs (for example, the costs of manpower, equipment, materials and utilities). No ceiling is placed on the value of grants. Since 1981, 85 projects have received RDAS funding to the value of $S58 million ($A40m) (SCS 1990).

SCS also administers the Science Park of Singapore, a dedicated R&D facility housing 50 tenants (including 45 private companies). Science Park tenants spent $S86 million ($A61m) on R&D in 1988-89, of which 40 per cent was by the five public sector tenants (SCS 1990).

The Product Development Assistance Scheme assists local product design, development capability and technological know-how. It provides cash grants to cover 50 per cent of direct development costs (for example, manpower costs, consultancy fees, overseas travel, and charges for patent searches, testing and developing prototypes). In 1988, the EDB paid out around $S2.1 million ($A1.5m) in grant assistance to 14 new projects.

SMEs also receive assistance through the Singapore Institute of Standards and Industrial Research in applying for overseas certification, obtaining third-party verification and information on overseas technical requirements. Grants to cover the costs of the assistance are available through the EBD's Small Industry Technical Assistance Scheme (SISIR 1990).

VII.4 Effects of Singapore's export enhancement measures

Hard evidence on the effectiveness of Singapore's export enhancement measures is difficult to come by. The Commission is not aware of any quantitative studies of the overall effect of these measures on the economy, and little analysis appears to have been undertaken in respect of specific measures.

Political stability appears to have been the most important reason for investment in Singapore. But investment incentives have mattered. According to a recent study of 71 foreign corporations in Singapore (Kng *et al* 1988), investment incentives and good infrastructure constitute the second and third most important factors (Table VII.3).

Table VII.3: **Factors inducing foreign firms to locate in Singapore**

Motivating factor	*Ranking*
Political stability	1
Investment incentive	2
Good infrastructure	3
Low wage	4
Disciplined labour force	5
Good government	6
Risk free	7
Other	8

Source: Derived from Kng *et al* 1988, p.87

VII.5 Concluding Comments

Singapore has successfully exploited its advantage as an entrepôt port, investing heavily to maintain its port as a centre of transhipment. Not well endowed with natural resources and without a significant domestic market, Singapore was also forced to exploit commercial opportunities on world markets.

Over the past four decades, the Government has facilitated the development of Singapore as a major trading centre through the provision of export and investment incentives, and substantial investments in infrastructure support. It has pursued a pro-business policy, for example by varying the level of compulsory employer contributions to superannuation (as a means of maintaining profits) and by direct investment in the shares of enterprises deemed important for development. Foreign corporations have been the beneficiaries of much of this support. The fact that Singapore is essentially a compact city-state probably made it easier for the Government to mould the social consensus necessary to establish and maintain its `export culture'.

There is no clear evidence to show that export enhancement policies have been the prime (or even a particularly important) cause in bringing about net increases in Singapore's trade/GNP. While it is arguable that export incentives were important in the early stages of Singapore's development, this proposition is hard to maintain as a generalisation. Increasingly Singapore's competitors were matching its incentives. It has been Singapore's overall business environment which has conferred on it an advantage and, in this sense, factors such as political stability, relatively low wages and access to efficient infrastructure are important in explaining its economic success.

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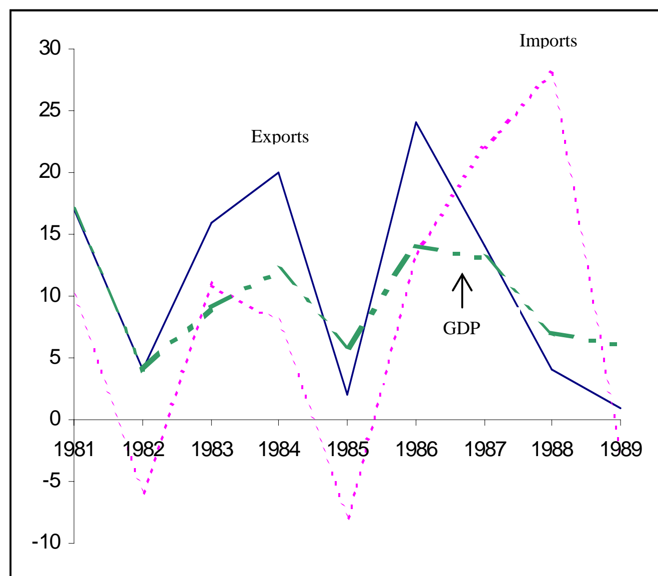
VIII TAIWAN

Taiwan is the world's twelfth-largest trading economy. In 1990, exports of goods and services were equal to almost 50 per cent of GDP. Taiwan has achieved average annual GDP growth of some 9 per cent in real terms since the 1950s, and it has had trade surpluses since 1976. The course of Taiwan's real GDP and trade growth since 1980 is shown in Figure VIII.1.

Taiwan now faces several adjustment problems as a result of its rapid export-led growth. Increasing labour costs, exchange rate appreciation and shortage of space to accommodate industrial expansion have begun to threaten the competitiveness of exports.

Figure VIII.1: **Taiwan's growth in GDP and trade: 1980-90**



Source: CEPD 1990b

VIII.1 Trade performance

Taiwan recorded balance of trade deficits between 1952 and 1970. Prior to 1960, agricultural commodities accounted for over 90 per cent of Taiwan's export income. Major export items included sugar, rice and bananas.

Although Taiwan's population (20 million in 1990) is not large in world terms, its high density and low income levels, combined with a relatively well-developed transport infrastructure, conferred a comparative advantage on it in labour-intensive manufactures during the 1960s. Consequently, industries such as textiles and footwear became Taiwan's export mainstays. This advantage was eroded during the 1970s as wage increases exceeded productivity gains. For example, in the ten years until 1983 incomes rose at an average annual rate of 14 per cent. As a result, Taiwan's comparative advantage shifted in favour of low energy-using manufacturing characterised by high value added -- such as electronics, plastics, chemicals and other machinery.

In addition, Taiwan's exports have increasingly been moving away from the lower end of the market. For example, five years ago Taiwan produced 800 million pairs of shoes with an average value of $US3; now it produces 200 million pairs with an average value of $10. Similarly, the

average value of Taiwanese bicycles has jumped from $50 to $150, while production has fallen by 27 per cent in volume terms. As this process has unfolded, design, innovation and brand identification have become integral to the marketing strategies of Taiwanese firms.

In 1990, Taiwan's major export sector was electronics and electric equipment, which accounted for 18 per cent of export earnings. Machinery and textile products were the next most important exports, accounting for 17 and 15 per cent respectively (see Table VIII.1). In the four years from 1985, the value of Taiwan's exports accounted for more than half its GDP. However, since 1989, export growth has slowed, and economic growth has fallen to around 6 per cent -- which is low by Taiwanese standards. The fundamental strength of Taiwan's economy is indicated by the size of its international reserves, which are the world's second largest. At over $US80 billion, they are some four and a half times as large as Australia's. An important stimulus to Taiwan's recent economic development is its economic relationship with mainland China, especially Fujian Province.

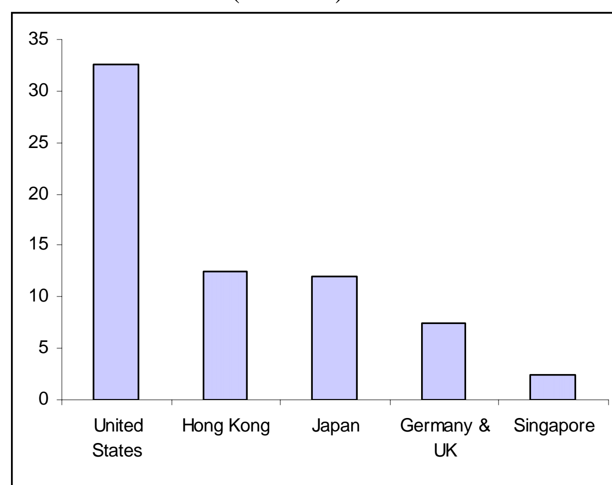
Taiwan has run a long-term trade surplus with its largest trading partner, the United States. Conversely, it has had chronic trade deficits with Japan, its second-largest trading partner. This is primarily because Japan is the major source of intermediate goods incorporated in Taiwanese exports, such as electronic components. Figure VIII.2 shows Taiwan's major export destinations.

Table VIII.2: **Major merchandise exports from Taiwan: 1990**
(Per cent)

Product group	*Proportion of exports*
Electronic and electrical equipment	18
Machinery	17
Textile products	15
Base metals and metal products	8
Plastics and plastic products	6
Footwear	5
Transportation equipment	5
Toys, games and sports goods	4
Precision instruments and apparatus	2
Leather and fur goods	2
Total merchandise exports ($A million)	**86 028**

Source: CEPD 1991a, p.32

Figure VIII.2: **Major destinations of Taiwan's exports: 1989**
(Per cent)



Source: CEPD 1990b

VIII.2 Trade and industry policy

Taiwan's development policy has been more open than some of its Asian competitors. With some exceptions (such as China Steel), the Government has refrained from large-scale intervention in the economy. This has enabled the continued domination of small-scale enterprise in the economy, in contrast with Korea's chaebol-dominated business community.

Trade and industry policy has been formulated as part of the successive economic development plans published by the Council for Economic Planning and Development (CEPD). The Government embarked on a substantial import-replacement program during the 1950s with US aid. This initiative caused adjustment problems for traditional export industries because it increased the cost of manufacturing inputs through tariff imposts. In addition, the exchange rate was maintained at an artificially high level. Nevertheless, manufacturing production doubled between 1952 and 1958. Towards the end of the 1950s, many industries had reached saturation point in terms of satisfying domestic demand.

Consequently, during the 1960s a `trade neutrality' strategy was adopted. This involved maintaining import tariffs while tightening fiscal and monetary policy and providing income tax and tariff rebates on goods incorporated into exports, and exchange rate rationalisation (that is, a uniform exchange rate for all exporters was introduced). Some export subsidies were also provided. The result was an economic environment which was much more conducive to exporting. Exports have driven Taiwan's economic growth since that time, with current account surpluses beginning to accumulate in the early 1970s.

During the 1980s, Taiwanese trade policy underwent significant liberalisation. Import barriers were reduced and the substantially undervalued New Taiwan dollar was revalued against the US dollar. Continuing trade surpluses throughout the decade had reduced the perceived need to promote exports. The flipside of these surpluses was that they precipitated increasing pressure from the United States for trade reform, as a result of its long-running bilateral trade deficit with Taiwan. Additionally, Taiwan has attempted to align its trade policy with GATT standards to strengthen its claim to membership of that organisation.

The Government has now withdrawn many of the more clear-cut export incentives such as intraindustry subsidies. Tariffs have been lowered and other import barriers, such as import licensing, have been (or are being) phased out. Thus, between 1968 and 1988 average tariff rates declined from 18 to 6 per cent. Further cuts are under way, with a targeted average rate of 3.5 per cent in 1992. Duty drawbacks are to be phased out by 1992 because the low levels of tariffs will obviate the need for them.

Recently, the Government has adopted an expansionary fiscal policy in an effort to stimulate domestic demand and reduce reliance on exports. This policy has also attempted to stimulate import demand to levels more commensurate with Taiwan's exports.

The most recent National Development Plan covers the six years from 1991 to 1996. Under this plan, some $US300 billion (around $A380b)[1] of public expenditure will be invested in such areas as telecommunications, housing and energy. The Plan particularly focuses on transportation, culture and education -- the development of which is seen not to have kept pace with economic growth. Economic liberalisation and industrial modernisation (especially through manpower training and R&D) are to be accelerated. The Plan envisages that average annual economic growth during this period will be 7 per cent, and per capita GNP in 1996 is projected to grow to some $A18 000 -- double the 1990 level. The current account surplus is projected to fall from 6.1 per cent of GNP in 1990 to 0.5 per cent in 1996.

Currently, the thrust of industry policy is to enhance the quality of the manufacturing base rather than to expand it, notably through the Statute for Upgrading Industry (see below). Manufacturing currently accounts for 34 per cent of GDP, down from 40 per cent three years ago, a level only ever paralleled by Japan and the Federal Republic of Germany. The service sector is growing more rapidly, and is projected to account for over half of GNP by 1996.

VIII.3 Export enhancement measures

Today tax incentives comprise the bulk of Taiwan's export enhancement measures, although a range of other measures are also employed. Increasingly, export enhancement is only one of several objectives of trade and industry policy.

Export marketing assistance

Taiwan has had several trade promotion and market development organisations since 1950. The China External Trade Development Council (CETRA) was formed in 1970. While it is a private organisation, Taiwanese companies have to pay CETRA a charge of 0.0625 per cent on their exports. It has a 31-member council, of which 26 represent private interests, and a brief to promote two-way trade. According to Austrade, CETRA has over 800 staff working in Taiwan and

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

overseas. The global budget for 1991 was reportedly around $A100 million. Services provided by CETRA through its overseas offices are still substantially free, but fees are progressively being introduced at home and are likely to increase in the future. General trade promotion activities undertaken by CETRA, especially trade fairs open to the public (as opposed to those to which entry is by invitation), are funded by the Government.

CETRA's activities include:

- trade promotion and market development;
- information services, such as computer networking to many local businesses, who are informed by electronic mail of new trade inquiries;
- exhibition promotion;
- trade education, including postgraduate training programs;
- help with product design and packaging; and
- campaign design for overseas marketing programs.

Keesing (1988, p.8) considers that, along with Hong Kong's Trade Development Council, CETRA has been the most effective agency of its kind in the developing world. He adds, however, that it was established some time after Taiwan first achieved export success, so that it must have played a supplementary rather than a causal role in this success.

Export finance assistance

Export finance assistance in Taiwan dates back to 1957 when the Bank of Taiwan initiated a system of low-cost loans for export. The newly created Central Bank replaced the Bank of Taiwan as the issuing authority for these loans in 1961. Ordinary commercial banks made loans which were then refinanced through the Central Bank. A firm's entitlement for concessional credit depended on its export performance in the previous year, as well as its planned exports for the current year. Alternatively, loans could be obtained by presenting letters of credit for export orders already in hand.

In practice, some firms tried to get credit through both channels, selling the extra on the lucrative `curb' (or unofficial) market. The effect was to bring down the average domestic interest rate, and lessen the impact of the preference for exporters. (The unofficial finance markets have been important in Taiwan, contributing 30-50 per cent of all lending including a significant proportion of export finance (TMS 1989, p.14; Wade 1990)). As a result, together with Taiwan's strengthening export performance, concessional export credit operations were wound back. By 1979, the difference between unsecured loans and export loans was 4 per cent (compared with 7 per cent at that time in the Republic of Korea). By 1981, export credits as a proportion of total bank loans had fallen to 2.1 per cent -- a third of the level a decade earlier. The margin of preference for exporters was also reduced.

The Central Bank continues to provide subsidised export credits. However, their operational importance to exporters has lessened, as Taiwan's economy has grown and with the development of Taiwan's substantial unofficial lending system.

The second major provider of assisted export finance in Taiwan is its Export-Import Bank (Eximbank), which was established in 1979. It provides short- and medium-term export credits, as well as loans for up to ten years on sales of equipment and machinery at subsidised rates (Herderschee 1990, p. 101). Additionally, it provides shipbuilding, overseas construction and investment credits under separate programs. It also offers standard insurance and guarantee arrangements to protect exporters (and importers) against political and commercial risk. According to Ball and Knight (1990), in 1989 Taiwan's Eximbank covered only 0.04 per cent of total exports.

Both the Bank of Communications and the Executive Yuan may invest in new or developing companies in `strategic industries'. Companies in these industries may apply to the Bank of Communications for preferential rate loans (Price Waterhouse 1989, p.32).

Tax incentives

Taiwan's general tax rate for companies is 25 per cent, and the top marginal rate for personal income tax is 40 per cent (over about $A150 000). The value-added tax (VAT) rate is 5 per cent. Other significant sources of government revenue are land tax, customs duties and commodity taxes (in declining order of importance).

A range of tax incentives is available to all `profit-seeking enterprises'. Further incentives are available to firms in certain industries. All incentives are available to local and foreign-owned firms alike.

These incentives were put in place by the *Statute for Encouragement of Investment (SEI),* which ran from 1960 till 1990. An important initiative of this statute was the provision of a VAT break on inputs incorporated into export items. The SEI sought to encourage investment in targeted industries or processes, and provided a range of incentives that would benefit enterprises of all sizes. The Government regards the SEI as having successfully promoted its targeted industries, with the exception of the automotive industry. A Senior Adviser to the President has noted that the business sector responded very positively to the Statute (Li 1991, p.36).

The *Statute for Upgrading Industry (1991-1998)* (SUI) recently replaced the SEI, and provides self-selecting tax incentives to industries undertaking high-technology production. Important tax-based benefits associated with this program include:

- Accelerated depreciation for equipment used exclusively for R&D-related activities; and

- Corporate income tax concessions of 80-95 per cent, which are obtainable by companies investing in automated industrial equipment, pollution control equipment, R&D or the creation of an international brand image. If the tax credit exceeds current tax liabilities, the company can carry the credit forward for up to four years.

These incentives have a functional basis, so that any industry using selected technologies is eligible for the associated incentives. Annual expenditure on these and other SUI incentives amounts to some $A180 million.

The following export-related incentives are available to all enterprises:

- VAT is not applied to exports of goods and services; and
- raw materials imported for processing and re-export are exempt from import duty, harbour dues and commodity tax, if re-exported within a specified period.

Further, enterprises organised as limited liability companies are entitled to a tax break on financial reserves maintained for losses arising from export activities. Such reserves may not exceed the previous year's export sales.

Infrastructure

Taiwan's infrastructure was well developed after World War II. Its high quality encouraged economy-wide investment and the utilisation of the large low-income workforce in regional areas for manufacturing. The infrastructure will be augmented under the current (1991-1996) National Development Plan. The Plan aims to strengthen the economy in areas such as transport, education and communications which the Government has identified as essential for high-technology industrial development.

Export processing zones

Taiwan was a pioneer in the establishment of EPZs, which combine the benefits of free trade zones and industrial parks. Three EPZs have been established -- in Kaohsiung, Nantze and Taichung. Each provides well-developed factory sites or pre-constructed buildings which are served by water and power supplies, as well as harbour and transportation access, financial agencies and government administrative offices. The Government leases each site to manufacturers. An important lesson of the first EPZ at Kaohsiung was the need to locate close to labour supplies, an aspect which was stressed in the location of the later zones.

Enterprises from 25 industries are permitted to locate within EPZs. Companies operating within these zones are eligible for all of the export enhancement measures discussed above, as well as considerably lower administrative costs than companies elsewhere in Taiwan normally incur.

Further, products imported for use and re-export are exempt from import duties. Commodity taxes and VAT are also waived, provided the goods are exported.

Herderschee (1990, p.74) considers that the EPZs were important in attracting Japanese firms to Taiwan, because they felt more secure in the zones. Some of the investment they attracted, however, would perhaps have happened anyway.

In addition to the three EPZs, 67 industrial parks have been established around Taiwan, 11 of which were privately constructed. Most of these target specific industries, and provide high-quality infrastructure facilities. Concessional loan finance is available to firms in these parks.

A third type of investment zone is the Hsinchu Science-based Industrial Park. Details of this are in Box VIII.1.

Research and development

In 1979, the Government introduced the Science and Technology Development Program to foster skills in science and technology for both the domestic and export markets. Since then, a range of projects has been initiated.

The current National Development Plan includes a strategy to accelerate the pace of industrial restructuring by:

- increasing R&D spending and strengthening co-operation between public and private research organisations to improve R&D efficiency;
- encouraging establishment of venture capital companies;
- offering tax incentives to induce private investment in `high-tech' R&D;
- further developing the Hsinchu Science-based Industrial Park; and
- planning for the construction of a `technopolis' to integrate regional scientific and technological development (CEPD 1991b).

The details of the Plan specifically refer to promotion of ten key industries, especially those using high-technology processes. The industries are: communications, information, consumer electronics, semiconductors, high-precision and automated machinery, aerospace, high-grade materials, special-application chemicals and pharmaceuticals, medical technology and pollution-control technology (CEPD 1990a).

Export promotion cartels

In addition to the above official export incentives, various manufacturing industries have formed export-promotion cartels. Several markets in Taiwan reached saturation levels in the 1950s and 1960s as a result of fierce domestic competition.

Box VIII.1: **Hsinchu science-based industrial park**

Taiwan's only science-based industrial Park was established in 1980 at Hsinchu. Its objective is to promote innovation in industrial technology and research. Park participants receive similar tax incentives and `one-stop-shopping' for government services as export processing zone participants. Companies from all industries are eligible for entry, contingent upon substantial R&D expenditure. Incentives associated with this facility include:

- a five-year exemption from corporate income tax, the exemption starting up to four years after a company's commencement at the Park; or a five-year period of accelerated depreciation on production equipment. Similar exemptions apply to the portion of income generated by new investment at later dates; or a 15 per cent investment credit on such projects. (This incentive is also provided to some investments outside the park.);

- business and other taxes on science-based enterprises are not to exceed 20 per cent of annual business income;

- exemption from import duty, commodity tax and VAT for inputs for export production;

- special low-interest loans and assistance with start-up financing and rental of facilities;

- government venture capital investment and grants; and

- equity capitalisation of investors' patents and know-how.

The Park is funded by a 0.25 per cent levy on company sales, having also received some $A640 million in Government investment funds (mainly for land acquisition and development). Hsinchu has begun to play an important role in Taiwan's industrial development. For example, it is responsible for about 90 per cent of Taiwan's integrated circuit production and 40 per cent of its personal computer output. By 1996, the Park is projected to have an output of $A8 billion and to employ 50 000 people.

As a result, the Government encouraged the formation of industry cartels to regulate output and promote exports, and to perform the following role:

> These sectoral associations function by collecting from their member firms an agreed amount for a so-called co-operative fund. The fund thus established is used to pay out an agreed amount of so-called export bonuses to the exporters of finished goods. Each firm is allocated an export quota in proportion to its output, and is required to pay a penalty to the co-operative fund if its export sales fall short. The exact content of the agreements signed between the firms must be submitted for approval by the proper government agencies (Lin 1973, p.106).

These subsidies were made possible by the high levels of protection operating during the 1960s. It has been calculated that the value of these offsets were equivalent to 2 per cent of manufactured exports, and affected 26 per cent of total manufactured exports. Explicit intraindustry subsidies were curtailed in 1974, but exports at less-than-average cost continued, although these had ceased by 1986 (Herderschee 1990, pp. 83-5).

More recently, the focus of these cartels has changed to restricting excess competition in export markets (Wade 1990, p.143). Now that Taiwan's firms are large players in such markets, the costs of such competition are similar to those that applied in the domestic market prior to 1970.

VIII.4 Effects of export enhancement measures

Quantitative analysis of the economic effects of the measures considered above has not, to the Commission's knowledge, been undertaken for Taiwan. Hence, definitive conclusions regarding the costs and benefits of these measures are elusive. However, several studies are available, albeit dated, concerning the general levels of assistance.

Wade has argued that, rather than tilting the absolute balance of policy measures in favour of the export sector, the Government used export incentives to offset the costs imposed by protection of other sectors. Taiwan's overall incentive framework thus approaches `trade neutrality', in that relative prices imitate those that would apply under free-trade conditions. Although it is rather dated, the information in Table VIII.2 supports this contention by showing the difference in incentives to export sales and domestic market sales in Taiwan and five other economies. From the first row of the table it is evident that Taiwan had the lowest overall trade bias. In other words, the balance of incentives in Taiwan's economy approached `trade neutrality' (Wade 1990, pp. 54-5).

These results are supported by work done elsewhere. In a sample of 31 developing economies (excluding Taiwan), Argawala (1983) found a strong inverse correlation between price distortion and economic growth. Wade (1990, p.300) calculated Taiwan's price distortion score by the same method, and found that it had the second lowest score in the sample. Further, Taiwan had the second highest growth rate.

Table VIII.2: **Differences in effective subsidy rates for export and domestic market sales in six economies**
(Per cent)

	Taiwan	*Korea*	*Singapore*	*Israel*	*Columbia*	*Argentina*
All manufacturing industries	4	7	-5	44	-22	-145
By trade orientation						
Export	12	31	0	-130	10	-91
Import-competing	-46	-61	-3	-88	-76	-190
Export & import-competing	-4	-46	-7	-65	-15	-164
Non-import-competing	21	16	3	-5	-4	-153

The figures in this table are found by subtracting the effective subsidy rate for domestic sales from the corresponding rate for export sales. Thus, a positive number indicates that sale for export is favoured relative to domestic marketing. The base years were 1967 for Singapore, 1968 for Korea and Israel and 1969 for the other economies.

Source: Wade 1990, table 3.3, derived from Balassa and Associates 1982, table 2.5

What seems clear is that, where the Government has provided assistance, it has directed it to industries considered to have some comparative advantage. In practice, this meant encouraging labour-intensive manufactures up until the early 1970s, and more capital-intensive production since that time. For example, the Government fixed agricultural prices in the 1950s and 1960s so as to encourage lower wages and higher industrial investment and profits. Additionally, adequate infrastructure (roads, electricity and water) was put in place in remoter areas to enable the utilisation of labour there. Wade (1990, p.302) captured the gist of this approach:

> Almost certainly some of Taiwan's industries and some of its exports would not have been initially profitable without state encouragement. That they were profitable after the event reflects the use of the price mechanism to validate investment decisions taken on grounds other than of current efficiency. The government pushed and pulled the structure of relative prices to secure a pattern of growth which it mapped out in advance in rolling plans.

This has been a continuing process, evolving with Taiwan's changing comparative advantage. A study by the Taiwan Institute for Economic Research shows that in the two years to the end of 1987, the share of exports accounted for by the most labour-intensive industries dropped from 34 to 28 per cent. During the same period, the export share of the most technology- and capital-intensive industries rose from 25 to 32 per cent (Dijk and Verbruggan 1987). It is these latter industries which are targeted for assistance under the current Plan, although this assistance will be general, rather than specifically aimed at export promotion.

VIII.5 Concluding comments

Taiwan has experienced a remarkable transition from the poor agrarian economy it had in the 1950s to the current situation in which intense competition between thousands of small-and medium-sized manufacturing companies provides a large export base. Political necessity, a sense of common purpose and a chronic need for foreign exchange have spurred this development.

The Taiwanese Government has used export enhancement measures to counterbalance its import-substitution policies, and to stimulate the accumulation of enormous foreign currency reserves. But there is no clear evidence from the literature, nor from the Commission's visit to Taiwan, that the export enhancement policies have actually been responsible for a net increase in exports or in GDP. Rather, the overwhelming impression is that political stability, a sense of common purpose, relatively low wages and comparatively well-developed infrastructure have been the prime factors in Taiwan's economic success, along with intense domestic competition between the many small- and medium-sized enterprises, substantial foreign aid and access to the United States market at important times.

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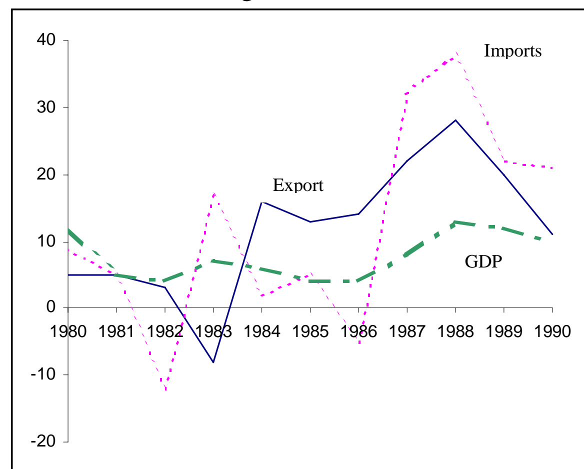
IX THAILAND

Thailand is one of the fastest-growing economies in the world -- and this is largely attributable to the expansion of exports. The changes in GDP and trade are illustrated in Figure IX.1. Between 1965 and 1990, GNP per head grew nine-fold, but remains well below that of near neighbours such as Malaysia and Singapore.

Starting with a poor, underdeveloped agrarian economy, the Government of Thailand in its First National Economic and Social Development Plan in 1961 made a conscious decision to raise living standards through industrialisation. Early policies concentrated on import replacement and protection of existing industries, with very high levels of assistance being extended to some activities.

Figure IX.1: **Thailand's grwoth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: IMF 1991

Annual real GDP growth in the 1960s and 1970s averaged 7 per cent; in the first half of the 1980s this fell to around 5.5 per cent as the economy was hit hard by the global recession and accompanying downturn in commodity prices but, following the recovery in 1987, has since averaged over 10 per cent. According to Robinson et al (1991), while Thailand's recent success can be attributed to many factors, three predominate: a commitment to an outward-oriented, market-based economic system; a development strategy centred on the private sector; and a tradition of cautious financial policies.

Thailand is generously endowed with natural resources. About 40 per cent of the total land area is cultivated, and some 29 per cent is under forest. Rice remains the staple cash crop, although its dominance has declined in recent years. Until the ban on commercial logging, Thailand was also a major producer of timber, particularly teak. Thailand's mineral resources include tin, brown coal, iron and manganese, with substantial deposits of sapphires, rubies, and other gems. There are also considerable reserves of natural gas (which now accounts for nearly one third of Thailand's energy needs) and, to a lesser extent, crude oil.

Agriculture is now one of the slower growing sectors, but rice, rubber, sugar and tapioca remain significant earners of foreign exchange. Although the agricultural sector now accounts for only about one-fifth of GDP, it remains the most important sector in terms of providing employment, with two-thirds of all employees. Growth in recent years has increasingly come from industry and services, which now account for 80 per cent of GDP.

Table IX.1: **Merchandise exports from Thailand: 1980 and 1990**
(Per cent)

Sector	*1980*	*1990*
Manufacturing	32	75
Agriculture	47	17
Fishing	4	6
Other goods	5	2
Mining	12	1

Source: BOI 1991b

IX.1 Trade performance

During the 1980s the composition of Thailand's exports of goods changed markedly to the point where manufactures now predominate (Table IX.1). For example, textiles have overtaken rice and a number of manufactured products have become major export items, including integrated circuits, canned fish and footwear.

Since 1986 in particular, manufacturing output and exports have not only increased but become more diversified: more than half of the export growth over the period has been due to non-traditional exports, including computer parts, consumer electronics, travel goods, and toys. The driving forces underlying the expansion have been twofold: first, a boom in manufacturing exports, which have grown by an average 29 per cent annually in volume terms during the period; and second, a surge in private investment, particularly in the export-oriented manufacturing sector, whose share in GDP more than doubled, from 14 per cent to 29 per cent between 1986 and 1990 (IMF 1991).

Thus, manufacturing in the late 1980s accounted for nearly 10 per cent of employment, but over one-quarter of GDP and three-quarters of merchandise exports. This sector has also been responsible for the bulk of imports, in the form of capital equipment, as well as inputs for further manufacture (and re-export).

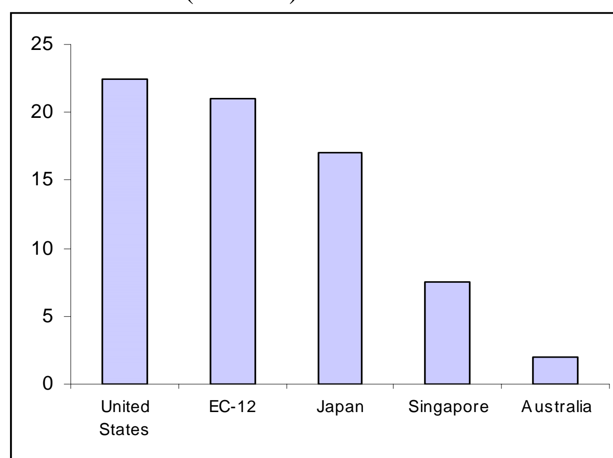
Thailand's major export markets are the United States and Japan -- see Figure XI.2. Japan is by far the major source of imports to the economy.

IX.2 Trade and industry policy

Thailand's postwar development can be broadly divided into three phases. The first (1950-72) was characterised by rapid growth and development, driven from the late 1950s by the adoption of an industrial strategy that was oriented to the private sector and by a rapid improvement in infrastructure. The second (1973-85) was dominated by the need for domestic adjustment in the face of severe external shocks: attempts to maintain growth through expansionary policies in the late 1970s were followed by a series of adjustment programs designed to restore internal and external balance. From 1986 onward, these adjustment efforts, aided by a favourable external environment, began to bear fruit.

From the late 1950s, although Thailand embarked on industrial development through an import-substituting strategy, tariff rates ranging from 15 to 30 per cent remained low compared with most other developing countries. However, during the 1970s, even as the emphasis of industrial policy swung increasingly toward export promotion, tariff rates were increased substantially, doubling the average rate of effective protection (Robinson *et al* 1991).

Figure IX.2: **Major destinations of Thailand's exports: 1990**
(Per cent)



Source: GATT 1991, vol. 2, p.69

No attention was paid to exports of manufactures in the 1960s. For a while, the domestic market absorbed increased output but, by the end of the 1970s, it appeared little further growth could be secured in this way.

> During the 1960s there was little concern for the promotion of manufactured exports. In fact, Thailand was able to develop its industries without much foreign-exchange constraint, since foreign-exchange earnings in service income, direct investment inflows and inflows of foreign aid and loans more than offset the trade deficits resulting from increased imports of capital and intermediate goods. By the 1970s, however, the growth rates for a number of import-substituting activities decelerated. The balance of payments was also in deficit during 1969Ä71 after a long period of surpluses. It was during this period that promotion of manufactured exports was seriously considered by the economic planners, and various incentives for manufactured exports were devised in the early 1970s (Supote *et al* 1990, p. 68).

Major incentives to increase exports (in the form of relief from import duties and from business taxes) were offered in the early 1970s. Nevertheless, the combination of assistance to various import-competing sectors and of other controls on trade and investment meant that there was little, if any, positive assistance to exporters (Linnemann et al 1987 pp. 298-99).

From the early 1980s, a reversal of this buildup of trade barriers became an important policy goal. Considerable progress was made in reducing non-tariff barriers, including the proportion of goods subject to import restrictions, and the use of specific import surcharges by the Board of Investment to protect domestic industries also declined sharply. Partly owing to fiscal restraints, less progress was made in reducing the level of tariffs, although their dispersion fell somewhat over the period: while many minor tariff reductions were implemented, the structure of tariffs remained broadly unchanged.

Since early 1990, however, as part of a wide-ranging program of economic liberalisation, trade reform has been stepped up. Indeed, for several years now, the Thai Government has adopted an open market approach -- reforming taxes (including the introduction of VAT), lowering import barriers and freeing up the financial system, including removing foreign-exchange controls. In 1991, the Government plans to further reduce public sector involvement in industry by partially privatising the Electricity Generating Authority of Thailand, the Telecommunications Organisation of Thailand and Thai International Airways.

Thailand's rapid growth has placed great strain on the existing infrastructure. Whilst early Plans emphasised creation and expansion of the country's infrastructure, recent growth has overtaken earlier efforts. The latest plan emphasises expansion of the telephone system, electricity generation, water, roads, ports and encouragement of higher education to provide suitably qualified people (eg engineers). Communication, power and water in particular have been stretched almost to crisis point. Private investment is helping solve the telephone problem. More generally, the Government is encouraging industrial development in less crowded areas and seeking to ensure that industrial estates are well serviced.

Encouragement of investment

Thailand actively encourages direct foreign investment as a means of promoting growth. There are a range of incentives offered to potential investors, under the general control of the Board of Investment (BOI). These incentives, provided under the 1977 *Investment Promotion Act*, are summarised in Annex A (page 129).

Incentives are only available to companies approved for this purpose by the BOI. The BOI maintains a policy of giving special consideration to investment projects which:

- significantly strengthen the balance of payments, especially through export production;
- support the country's resource development;
- substantially increase employment;
- locate operations in the provinces;
- conserve energy or replace imported energy supplies;
- establish or develop industries which form the base for further stages of industrial development; or
- are considered important or necessary by the Government.

The degree to which projects are `favoured' depends on the extent to which these desired features are satisfied. The level and form of assistance provided to an investor are generally determined by the BOI on a case-by-case basis within well-advertised guidelines. The most common measure is partial relief from corporate tax, but others include assistance with financing of factory buildings, relief from import duties and other taxes, and provision of infrastructure by the Government. There is a readily available list of activities which are eligible for investment promotion. From Annex A it can be seen that the incentives fall into two broad categories:

- guarantees that the Government will not arbitrarily interfere or place restrictions on the investor's operations, and will limit competition from other suppliers; and
- relief from certain taxes and duties -- for exports this usually means relief from import duties; and the granting of tax credits, based on the level and type of exports achieved.

While tax holidays are often quoted as being of decisive importance in assisting industries to locate in (and then export from) Thailand, the Commission was told during its visit to Bangkok that the concession is not particularly expensive in terms of tax revenue forgone, as few projects are profitable in the early years of operation.

In a similar vein, it was suggested that low labour costs were considerably more important that export incentives when locational decisions were being considered. Nevertheless, Japanese companies in particular seemed to expect they would be offered some incentives, but were more concerned to attain the stamp of government approval than particular concessions.

In 1989, there were 1170 projects receiving BOI promotion. Altogether, these projects employed 330 000 workers, or a little more than 1 per cent of the workforce. A very high share (over 70 per cent) of all BOI-approved projects export over 80 per cent of their production. Most proposals (by number) accepted for promotion recently have been for export-oriented light industry projects, but there have also been a number of major initiatives in the chemical and heavy industry areas. Some 60 per cent of new project approvals (by number) had foreign capital involvement.

Apart from the BOI, there are three subsidiary bodies to assist development -- the Industrial Estate Authority, Industrial Finance Corporation and Thailand Factory Development. These bodies develop estates, build factories for lease or assist in the design and erection of factory buildings, and with financing of new facilities.

IX.3 Export enhancement measures

The anti-export bias inherent in any tariff system has been reduced in Thailand by various export promotion schemes. For example, the Bank of Thailand has operated an export rediscount facility since 1958, providing short-term loans to exporters at subsidised interest rates; and since the early 1970s, export orientation has been increasingly important in determining the distribution of investment incentives. In addition, the operation of the various duty drawback schemes, which refund tariffs and business taxes on imports used to produce exports, has been significantly improved since the early 1980s; and institutional support to exports (such as export marketing and trade fairs) has been strengthened.

The material that follows provides more detail of the range of export enhancement measures offered by Thailand. All are elements of an overall policy designed to attract export-oriented investment. In the main, assistance is targeted at the newly establishing firm (although there are some elements aimed at providing continuing export support).

Export subsidies

The Commission has received no direct evidence that Thailand provides explicit export subsidies (other than forms of assistance discussed below). It notes, however, that there were three successful countervailing actions by the United States against Thailand in 1988. These related to exports of anti-friction bearings and types of pipe and pipe fittings which had been subsidised through the export financing facility discussed below.

Export marketing assistance

The Department of Export Promotion provides information on potential markets and buyers, as well as training in export techniques. It arranges and participates in international trade fairs and organises trade missions. The Department operates eight trade centres, including one in Sydney.

Export finance

Thailand's export finance arrangements have been much more directed at subsidising the costs of producers than the arrangements in, for example the United States or France, which are aimed at providing credit to customers. There may be some move towards the more traditional form of assistance once the Export-Import Bank (now being established) is fully operational.

The Bank of Thailand provides credit to exporters through a concessional rediscount facility with maturity periods of up to 180 days. This facility is operated through the commercial banks and the amount of rediscounted finance available depends on the supporting documents provided by the exporter -- for example, typical figures are 60 per cent of warehouse receipts and 90 per cent against bills of exchange (BOI 1990a, p.27). According to GATT (1991, vol. 1, p.144) the fastest growth in the use of the Bank of Thailand's scheme in the 1980s was for exports of canned food and frozen meat.

The Asian Development Bank has noted that the refinancing facility has been used more sparingly in Thailand than in other countries. The ratio of export finance to exports has been around 35 per cent. The Bank observes also that many smaller exporters miss out on access to this facility and that some larger companies have been able to abuse the system (Asian Development Bank 1990, pp.287-9).

The Commission was told during its visit to Bangkok that good relationships between the business and banking sectors had sometimes been very helpful in assisting exporters. The Bank of Thailand tends to be lenient when exporters have trouble collecting from overseas customers.

Taxation incentives

Central government taxes in Thailand in 1991 are of three types -- corporate income tax, individual income tax and business tax. Personal income taxes are on a progressive scale, with the highest marginal rate being 50 per cent. As well, there are import duties, a few excise taxes, export taxes (on a very limited range of commodities) and some other imposts.

A value added tax of 7 per cent was introduced on 1 January 1992 with exports zero-rated. The VAT replaces a `business tax', a form of sales tax levied on gross monthly receipts of manufacturers and service companies. The business tax was also levied on the notional value of goods imported, the rates varying with the types of business and the type of product.

Corporate income tax is generally at the rate of 35 per cent (30 per cent for companies listed on the Securities Exchange of Thailand). Incentives are offered in the form of relief from corporate or business taxes for activities approved by the BOI. In some instances, to gain BOI approval an investor must undertake to export a minimum level of production. For example, to gain investment promotion approval for the manufacture of some sports equipment, an investor must undertake to export all production. Such requirements appear to apply mainly to forms of production already well represented in Thailand.

Fairly standard arrangements apply to drawback of import duties on goods used in the manufacture of exports, and there are also arrangements allowing manufacture in bond. In addition, Thailand has a special scheme to rebate some of the taxes paid by companies indirectly involved in export. Under the *Tax and Duty Compensation of Exported Goods Produced in the Kingdom Act 1981,* rebates have been allowed on customs duties, business taxes, excise taxes, municipal taxes, and other taxes included in the cost of materials, machinery, equipment, spare parts, fuel and power. A prespecified 180 sector input-output tabulation is used to calculate the import content of exports. Rebate rates have been calculated for more than 5000 product types, but according to GATT (1991, vol. 1, p.140):

> Since average input coefficients of the whole sector, rather than the coefficients derived from the actual input used, are the basis of calculating import duty, refunds paid to exporters do not necessarily reflect the actual duty paid by them.

Rebates are paid in the form of tax credit certificates which can be used later in paying other taxes.

Export processing zones and industrial estates

The Industrial Estate Authority of Thailand was established by the Government in 1972 to develop areas of land by providing basic infrastructure and associated utility services for the siting of industrial plants. Thus far, it has been involved in the establishment of five operating estates and is developing two large estates in the Eastern Seaboard area. These are associated with new deep-water ports and are primarily intended to be developed for oil refining and chemical works.

In recent years the Government has promoted the establishment of private sector industrial estates. For example, a March 1991 list of `Activities eligible for investment promotion' (published by the BOI) refers to industrial estates, but also to an international trade exhibition centre, mass transit systems, concession expressways and airport facilities. There are now a total of 37 industrial estates either in operation or under construction.

Twelve of these estates contain EPZs, making up about one-tenth of the total industrial estate area. Firms located in EPZs are exempt from import duties and business taxes on factory construction materials, machinery, equipment and inputs needed for manufacture of exports. Within the EPZs, foreign investors are permitted to own land, bring in foreign technicians and factory experts; and to remit foreign exchange abroad.

There are also special taxation concessions. Firms in EPZs can deduct from taxable income 5 per cent of the annual increase in export revenue (excluding freight and insurance). As well, a 10 per cent discount on electricity costs is allowed for five years from the beginning of operations, and certain transport costs are reduced by 10 per cent (GATT 1991, vol. 1, p.143).

Industrial estates are an important part of Thailand's development strategy, but EPZs (in a pure sense) do not seem to be especially important. Most of the incentives offered are available to companies accorded promotional status by the BOI irrespective of their being located in an EPZ.

Research and development

There are two institutes providing assistance to encourage R&D. The Commission has no information on the sums involved or the targeting of the funds.

IX.4 Effects of export enhancement measures

Effects on the Thai economy

From its discussions in Thailand, the Commission has the impression that there has been little rigourous analysis of the effects of export incentives. Even at the intuitive level, opinions on success varied. Many observers considered the incentives had an important role in encouraging an export culture by emphasising that the Government was `onside' with exporters. At the same time, the reduction in regulations and the generally outward-orientation of the nation were seen as having been very influential. It was also suggested that some very successful areas of export growth (such as jewellery) had attracted almost no export assistance.

The export refinancing facility appears to have some impact on the level of exports, but there has been considerable concern about other effects of this arrangement. The demand for subsidised credit through this avenue has, in part, been because of the ability to divert the subsidised credit to other uses. This has placed strains on the financial system with rising interest rates and an expansion of the money supply (Asian Development Bank 1990).

Despite significant reductions in tariff barriers in recent years, they remain high. For many types of production, tariffs cascade -- import tariffs rise with the stage of processing. This has led to very high levels of effective assistance to some sectors, including a number of export industries. For example, the clothing industry receives high assistance in this way. This assistance, while of no direct help on the export market, may assist by establishing a secure domestic market. There is, of course, a very significant cost to the domestic consumer in such an approach.

Effects on the Australian economy

Recently, Thailand has begun to export a range of canned fruit and vegetable products which might have some impact on Australian producers. There is nothing to suggest these exports are being

greatly helped by government incentives, other than that such activities are included in lists of projects eligible for promotion by the BOI, and that exporters of canned foods have been major users of the Bank of Thailand's export finance arrangements. At the other end of the scale, the activities of the BOI are aimed at encouraging Australians (and others) to take advantage of whatever subsidies or incentives are available to invest in Thailand.

The Commission was told by the managers of Australian-owned operations in Thailand that proximity to raw materials, protection against imports, and tax incentives, as well as industrial problems in Australia had all had a part in the decision to locate in Thailand.

IX.5 Concluding comments

The Thai economy has undergone major structural adjustment in the last three decades, evolving from a mainly agrarian economy to become a significant exporter of manufactures and services (especially tourism). This change is seen by many as the product of foreign direct investment in manufacturing and local investment in necessary supporting infrastructure. Certainly, Thailand has been enthusiastic in seeking investment from abroad.

Thailand is one of the fastest growing economies in the Asia-Pacific region, its growth being associated in the main with expansion of a manufacturing export sector. A series of seven Plans have consciously sought to raise living standards and, especially in the most recent Plans, export expansion has been seen as the engine for this growth. However, rather than rely on encouraging its existing industry to move into exports, the Thai Government has concentrated on encouraging and attracting investment in industries which will naturally look to export markets. Many of the industries attracted have only small opportunities in the domestic market.

Thailand's approach -- a mixture of a large, low wage and enthusiastic workforce, investment incentives, and general government encouragement -- appears to have worked. Some Thais are now beginning to ask what costs have been associated with the encouragement.

The success of Thailand's sustained economic performance has led to increasing strain on the economy, manifested in the emergence of infrastructure bottlenecks, a sharp increase in the current account deficit, and a pick-up in inflation. The challenge facing policymakers now is how best to sustain the momentum of the economy while keeping demand pressures in check. This in turn will require measures to reduce a variety of structural impediments to growth. In particular, the need for substantial infrastructural investment in both physical and human capital is widely recognised and, to support this, a strengthening of domestic savings is required. The deregulation of domestic markets is seen as essential to improve economic efficiency and enhance the potential for growth, particularly in the areas of tax reform, liberalisation of the financial system, and tariff reduction.

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X NEW ZEALAND

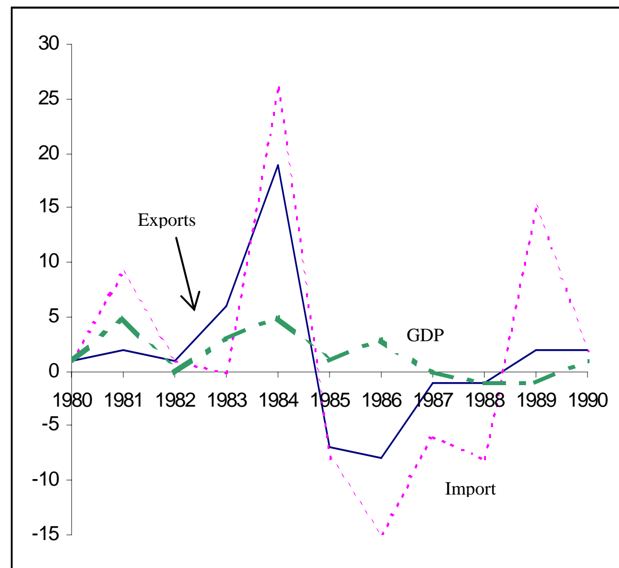
In the 1980s, New Zealand's economic growth was slow and GDP *per capita* fell well below the OECD average. The country has had persistent balance of payments problems which have created a heavy overseas debt burden. This debt stood at 36 per cent of GDP in March 1989. Real GDP growth over the 1980s averaged just under 2 per cent (Figure X.1).

While predominantly known as an agriculturally based economy, there has been a long term decline in the proportion of agriculture comprising GDP, from almost 15 per cent in the early 1960s, to almost 6-7 per cent in the second half of the 1980s.

X.1 Trade performance

New Zealand exports increased quite strongly in the early 1980s: indeed by 18.5 per cent in real terms in 1984. Over the remainder of the decade, however, exports declined substantially -- as did imports, reflecting the general slow-down in the New Zealand economy. There were some signs of improved export performance towards the end of the 1980s. In 1990, exports increased by 2 per cent in real terms -- the first such increase for six years.

Figure X.1: **New Zealand's growth in GDP and trade: 1980-1990**
(Constant prices, percentage change)



Source: IMF 1990

Agriculture accounts for by far the largest share of New Zealand merchandise exports -- 48 per cent in 1991 (Table X.1). The major export groups within the agricultural sector are meat and dairy products. Whilst agricultural products continue to be the mainstay of New Zealand's exports, the share of manufactures, including consumer goods, electric and non-electric machinery, office machinery and telecommunications, has been increasing over the last decade.

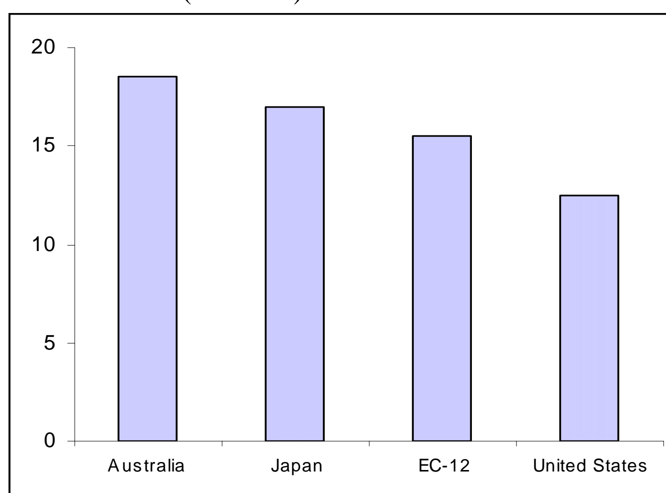
Table X.1: **Merchandise exports from New Zealand: 1991**
(Per cent)

Food & beverages	**48**
meat	17
dairy	17
other	14
Primary products	**19**
wool	6
wood/pulp	7
other	6
Metals & fuels	**11**
Manufactured products	**19**
Other exports	**3**
Total	**100**

Source: New Zealand Trade Development Board 1992

In 1989, over two thirds of New Zealand's exports were sold to Australia, the EC, Japan and the United States. There has been a trend towards North Asia. The share of exports going to China, for instance, have risen from 2 per cent in 1978 to 5 per cent in 1988, and the share to Japan has risen from 14 per cent to 17 per cent for the same time period.

Figure X.2: **Major destinations of New Zealand's exports: 1989**
(Per Cent)



Source: OECD 1991, p. 12

X.2 Trade and industry policy

Since 1984, New Zealand Governments have attached particular importance to trade liberalisation as an instrument for making the domestic economy more efficient. Two key principles have guided reform:

- industry assistance policy should be neutral between sectors; and
- industry should be exposed to the full extent of changes in world prices.

New Zealand faces serious quantitative restrictions on exports of its most important agricultural products. At the same time, it faces competition in third markets from subsidised agricultural exports from the major industrial economies. The Government is making efforts to secure better conditions of access to overseas markets and to enhance the marketing skills and information available to exporters.

Under the Australia New Zealand Closer Economic Relations (CER) trade agreement, each country has agreed (since July 1990) not to pay incentives or production bounties (subsidies) aimed at stimulating exports to the other.

X.3 Export enhancement measures

New Zealand has striven to improve the competitiveness of its export industries through a market-oriented approach rather than by perpetuating previous assistance policies. There are very few explicit programs left to assist exporters.

The Government provides export marketing assistance through the Trade Development Board (TDB) and the Export Growth Development Scheme (EGDS), and exempts exports from goods and services tax (GST). It provides export credit insurance only in situations where such cover is thought to be in the national interest.

Export marketing assistance

The Trade Development Board

The TDB provides much of New Zealand's export market assistance. It is fully funded by the Government and has 35 overseas offices and four regional offices in New Zealand.

The TDB facilitates trade development by sponsoring export opportunity awareness programs, trade fairs, visits by buyers and journalists, and joint action strategies with sectoral groups. It offers programs on a cost-share basis with the private sector bearing at least half the costs.

Expenditure in the 1990-91 financial year was $NZ51 million ($A37m)[1].

Enterprise Growth Development Scheme (EGDS)

This new scheme aims to help existing small- and medium-sized businesses become more internationally competitive. Because of the CER Agreement, the scheme does not apply for activities directed at the Australian market.

It is open to any individual, business or organisation resident in New Zealand which deals in internationally tradeable goods or services, has been trading for over 18 months, and is producing the goods or services in New Zealand (Table X.2).

Table X.2: **Activities qualifying for the EGDS: 1991**

Qualifying activities	*Maximum grant ($NZ)*	*($A)*
Market research	5 000	3 762
Exploration visits to new markets	7 500	5 642
Trade fair participation	10 000	7 523
Promotion and advertising in new markets	4 000	3 009
Protection of intellectual property rights	2 000	1 505
Proposal costs for development projects, after short listing	5 000	3 762
Costs of undertaking quality assurance audit/accreditation	3 500	2 633

Source: Minister of Business Development 1991

The maximum grant available to any one applicant is $NZ20 000 ($A15 000) per year. The scheme provides assistance for 50 per cent of approved costs up to this maximum.

Export finance

The New Zealand Government formerly operated the Export Guarantee Office (EXGO) which provided export insurance to cover for insolvency of buyers, buyer's default, buyer's refusal to accept goods, currency transfer delay or blockage, political disturbances, and changes in import restrictions. Its main business was short-term cover of primary produce contracts. This accounted for 56 per cent of business in 1988. In contrast to many export credit insurers around the world, EXGO made profits over the latter half of the 1980s.

The Government has sold EXGO to a private company -- State Insurance Ltd (SIL). Under the terms of the sale, SIL will underwrite new risks to its own account and at the same time will service the run-off of business previously underwritten to the Government account. SIL has retained the name EXGO and intends to continue offering the same range of services.

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

The Government has also contracted SIL to administer the National Interest insurance account. Where EXGO refuses insurance to an exporter, the Government may consider underwriting the insurance. The Government uses the following criteria to assess each case: the non-availability of private sector cover; foreign and trade policy objectives and priorities; the potential impact on other markets for the same or similar products; potential economic returns from the specific export market; implications of a denial of cover; and the prospect of risk sharing.

Taxation

The highest marginal personal tax rate is 33 per cent. The corporate tax rate is also 33 per cent for resident companies and 38 per cent for overseas companies.

The Government introduced a 10 per cent goods and services tax (GST) in 1986 to fully replace sales tax. The rate was increased to 12.5 per cent from 1 July 1989. Exported goods and services are zero-rated, and financial services are exempt.

X.4 Effects of export enhancement measures

Assistance to New Zealand exporters is now so small that it is unlikely to have a significant effect on the New Zealand economy or Australia's -- all the more so as the CER Agreement prohibits export subsidies.

X.5 Concluding comments

New Zealand trade policy changed significantly during the 1980s from inward looking to basically free trade. The Government has ceased most forms of export assistance. It now concentrates a small amount of resources on assisting New Zealand producers to market their goods overseas and underwrites insurance in special circumstances.

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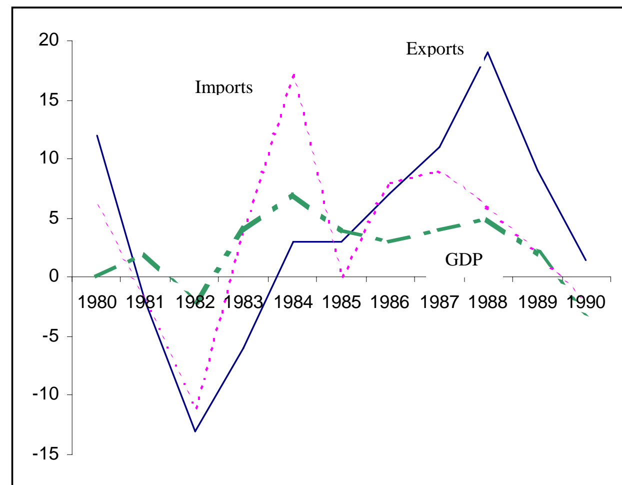
XI THE UNITED STATES

The United States is the world's major trading nation, Australia's major trading partner and a major competitor for Australia in some areas of trade. The United States plays a pivotal role in developing international trade policy, especially as this relates to the GATT and to the relationships between the three major traders -- the United States, the EC and Japan.

XI.1 Trade performance

At the beginning of the 1980s the United States' current account was almost exactly in balance. For much of the rest of the decade the nation ran a large current account deficit. The trade imbalance has fanned protectionist sentiment in Congress and has driven trade politics in the United States in the eighties. Figure XI.1 shows real change in the United States GDP and trade in recent years.

Figure XI.1: **The United States' growth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: OECD 1991, p.33

Table XI.1 shows that in 1989 the United States' exports of goods were dominated by manufactures. In general, exports of manufactures are concentrated in areas of machinery and electrical equipment.

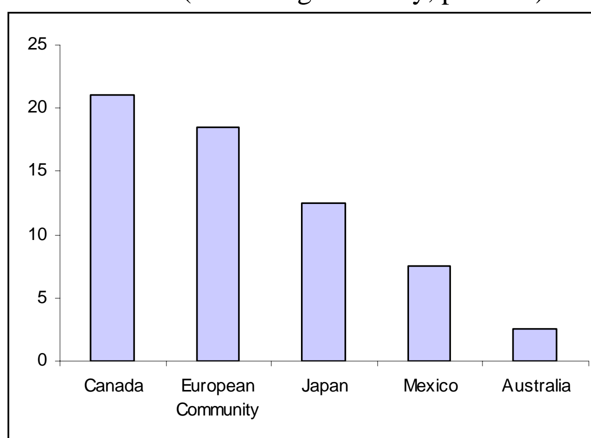
Table XI.1: **Merchandise exports from the United States: 1989**
(Per cent)

Machinery, transport equip	28
Chemical products	7
Foodstuffs	7
Raw materials	5
Motor vehicles	5
Fuels	2
Petroleum, petroleum products	1
Iron and Steel	1
Other manufactures	46

Source: OECD, Foreign Trade by Commodities, 1990

Figure XI.2 shows the importance of a number of trading partners to the United States. In 1989, Canada provided the largest single export market. Canada and Mexico together accounted for $US99b ($A132b) of exports.[1] Australia was the United States' 11th largest export market and 22nd most important source of imports.

Figure XI.2: **Major destinations of the United States' exports: 1989**
(Trade in goods only, per cent)



Source: OECD 1991

[1] $A estimates used in this report are expressed in terms of 1990 Australian prices.

XI.2 Trade and industry policy

The United States does not have formally enunciated industry policies: but it has trade policies, which can be directed at supporting an interventionist United States presence in the world economy.

The officially declared objectives of United States trade policy are to exploit the potential of international trade for creating jobs and improving the nation's standard of living; to maintain and strengthen the world multilateral trading system; to ensure equitable treatment for United States based firms in international markets; and to avoid undermining the credibility of United States based firms as reliable suppliers.

There are four principal instruments through which the United States enhances export performance: agricultural export support programs, leveraging access to the markets of trading partners for which the provisions of Section 301 of the United States Trade Act is the foremost instrument, provision of export credit programs and the Foreign Sales Corporation scheme to reduce the tax payable by exporters.

The United States has simultaneously supported international trade liberalisation and adopted protectionist policies. It has responded to the challenge of the superior competitiveness of Japanese exports since the mid-seventies by introducing a range of protectionist measures. It has also challenged trade barriers in Europe to United States exports, particularly agricultural products, as well as barriers to United States exports to Japan. It initiated both the Tokyo Round and Uruguay Round of GATT multilateral trade negotiations. This dualist approach to trade policy can be explained in the eighties by the interplay between Republican Administrations, which prefer liberal trade policies, and Democrat-dominated Congresses, which favour protection.

The United States has developed mechanisms for exerting bilateral leverage to gain access to the markets of its trading partners. The most notorious feature of interventionist trade policy is Section 301 of the Trade Act of 1974. Oxley has argued that demanding access to the markets of a trading partner through bilateral arrangements on grounds that do not exist under the GATT has two principal effects:

> The first is the thief effect. It is difficult to discourage someone else from being a thief if they see you stealing. It is worse if you are the leader of the scout troop. The United States has been the leader of the GATT scout troop since its inception. The second effect is to force countries to move some of their trade out of the GATT system. This is what happens if the United States imposes or raises a tariff on an import from a particular country because that country has not met a test which is not required under GATT but is provided for in United States trade law. The free trade principle of the GATT is that everybody has the right to trade with everybody else on the same terms. This is the principle that rewards the most efficient producer (Oxley 1990, p. 68).

XI.3 Export enhancement measures

Export subsidies

Other than the subsidisation of agricultural exports and insurance and credit arrangements for export there are no other direct export subsidies paid at the moment by the Federal Government.[2] The most prominent subsidies are those affecting trade in agricultural products. Subsidised interest is the principal form of support for exports of agricultural products, although direct export subsidies paid through the Export Enhancement Program (EEP) are probably better known. Box XI.1 outlines how the EEP and associated schemes work.

The policies underlying United States farm support programs and the success of the programs in meeting their objectives were examined in some detail by Roberts et al in 1989. The basic system of government intervention in the United States grains industry was developed to alleviate farm income and rural poverty problems in the wake of the great depression. At that time, rural production in the United States was mainly from small farms and directed to the domestic market. Gradually these problems have been resolved and the structure of the industry has changed greatly. Production now is primarily from a small number of large farms and exports are much more important. However, the same basic measures of price support and acreage regulation operate.

The EEP was introduced with the 1985 Food Security Act at a time of crisis in United States farm incomes, following the loss of much of the United States' export market share. Winning back lost markets was a principal stated objective of the program. Roberts et al (1989, p.6) warned, however,

> *The ostensible objective of obtaining a large market share for the nation may mask other aims: those of providing higher levels of support to farmers and sustaining high usage rates and thus profitability for suppliers of farm inputs and services (their italics).*

ABARE estimated that the total net support provided by the United States Government programs to wheat producers in 1987 88 amounted to 75 per cent of the market price, or US$1.94 a bushel against a market price of US$2.57. In comparison to that US$1.94 a bushel, in the same year the Canadian Government provided support of US$1.73, the EC US$3.73 and the Australian Government US$0.01 (*ibid* p. 76). Support was provided also to the producers of several other agricultural commodities.

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[2] There are a variety of State programs to encourage exports. For example, California has an Export Finance Program and South Dakota a series of programs and authorities to encourage exports from that State.

Box XI.1: **How the United States pays agricultural export subsidies**

The EEP is designed to encourage United States farmers to produce more than they would if they were paid only the world market price. The process starts with the Government setting a *loan rate* for the crop. For wheat this was $US2.06 ($A2.74) a bushel in 1989, which set a floor price. The farmer could pledge his wheat to the Government in return for a loan of this amount. If the market price turned out higher, the farmer could repay the loan (with interest) and sell at the higher market price. If the *market price* were lower, the farmer could default on the loan, ceding the crop to the Government. (The Government, by law, would keep the acquired surpluses off the market until the price reached a higher level, known as the *release price*.) The loan rate thus acted as a price support.

In addition, there is an income support device called the *target price* -- the minimum final price that farmers receive for their crop. At the end of the crop year, farmers receive deficiency payments equal to the difference between the target price and either the market price or the loan rate, depending on which is the higher. In 1988, for example, the target price for wheat was $US4.38 ($A6.08) a bushel, the loan rate $US2.28 ($A3.16) and the market price was $US2.60 ($A3.61). A deficiency payment of $US1.78 ($A2.47) a bushel was paid.

The United States Government has a range of programs to dispose of the surplus stocks it acquires, the most important from Australia's point of view being the EEP. In that scheme, government-owned stocks are given to private United States exporters who are thus able to sell at average prices below the United States domestic price into markets especially selected and targeted by the United States Department of Agriculture.

An EEP `sales initiative' states the targeted country and the quantity of a specific commodity to be sold there. Knowing that a subsidy is available, private United States exporters can offer to sell the commodity at prices below the market cost of acquiring it in the United States. The United States exporters then bid against each other (in terms of the dollars per unit subsidy required to make the sale) to receive the USDA's surplus stocks as a payment for the export subsidy. The bidder requiring the lowest subsidy is paid by the USDA with a generic commodity certificate. This can be exchanged (at its face value) for any of the surplus stocks held by USDA.

Source: Coughlin and Carraro 1988

Bilateral leverage

Probably the most aggressive United States Government tool for opening or expanding export trade in particular items is Section 301 of the *Trade Act of 1974.* Two senior United States officials have described it as `the main U.S. trade law designed to pry open foreign markets to United States investment and exports of goods and services' (Bello and Holmer 1988, p. 2). In the words of the GATT Secretariat:

> Section 301 of the Trade Act of 1974, as amended, has become an important instrument for improving access to foreign markets for exports of goods and services as well as for investment from the United States, and for the protection of intellectual property rights (GATT 1990, p. 160).

United States trade law authorises, and in certain cases requires, the United States Trade Representative (USTR) to take retaliatory action to enforce the rights of the United States under a trade agreement, or to eliminate foreign trade practices which the USTR determines as `unjustifiable', `unreasonable' or `discriminatory'.

- `Unjustifiable' practices are defined as any act, policy or practice that is in violation of, or inconsistent with, international legal rights of the United States, including those which deny national or most-favoured-nation treatment or the right of establishment or protection of intellectual property rights.

- The term `unreasonable practices' includes:

  (i) denial of fair and equitable market opportunities, including the toleration by a foreign government of systematic anti-competitive activities by or among private firms,

  (ii) denial of opportunities for the establishment of an enterprise,

  (iii)denial of adequate and effective intellectual property rights protection,

  (iv) export targeting, and

  (v) denial of certain internationally recognized worker rights.

- Practices which deny national or m.f.n. treatment to United States goods, services, or investment are treated as `discriminatory' practices.

The *Omnibus Trade and Competitiveness Act of 1988* introduced the so-called `Super 301' provision, designed to combat generic or systemic trade practices through the identification of priority practices and countries. The `Super 301' process applied only for 1989 and 1990. Once a `Super 301' investigation was initiated, the USTR was required to consult and negotiate an agreement with the countries concerned, which provided for the elimination of, or compensation for, the practice within three years. If an agreement were not reached within the prescribed time limits, the USTR was to determine whether the practice under investigation violated a trade agreement or was unjustifiable, unreasonable, or discriminatory and, therefore, actionable under Section 301. If the answer was yes, retaliation might be initiated.

Section 301 actions have been at the heart of United States programs to:

- increase semi-conductor sales to Japan;
- open the Korean insurance market;
- overcome restrictions on imports of meat to the EC (imposed on the grounds the meat contained prohibited hormones);
- open Brazil's software market;
- obtain quotas favouring United States exports of leather and leather footwear to Japan;
- open Hong Kong to American lawyers;
- break the state-protected tobacco monopoly in Thailand; and
- expand almond trade to India.

The United States has also exercised general bilateral leverage on other countries to increase imports from the United States. The most recent instance relevant to Australia has been United States pressure on the Japanese car industry o increase imports of United States automobile components.

Export marketing assistance

The United States equivalent of Austrade is the United States and Foreign Commercial Service. Part of the Commerce Department's International Trade Administration, it offers a range of services to help United States companies sell abroad -- on-the-spot market research, special market studies, searches for sales leads, qualified agents and distributors, making appointments with potential customers and government officials and providing general advice.

There are approximately 186 United States officials working in 67 countries (in 122 offices). Around half of these officers have been hired directly from the private sector. These are supplemented with around 525 foreign nationals *(Business America 1991).*

Another form of market development assistance comes through the Trade and Development Program (TDP). This concentrates on major development proposals for middle-income and developing countries. It funds feasibility studies, orientation visits to the United States by foreign officials, training programs and a number of associated activities. Like Eximbank, it rationalises its role as defending the United States share of the world market. In its 1990 annual report to Congress it reported:

> Developing country markets, however, are particularly difficult ones for US firms to penetrate because of the strong competition from foreign firms ... In almost every case ... the host country has the option of obtaining a grant from another donor government. Typically, these grants are made to promote procurement from the donor nation, thereby virtually locking US firms out of major projects at the implementation stage (TDP 1991, p. 3).

In May 1990 a Trade Promotion Coordinating Committee was formed by the President to unify and streamline Federal trade promotion activities including: collection and analysis of market information; trade events and missions; dissemination of information on export financing; identification of possible joint venture partners; and counselling on foreign standards, testing and certification requirements. A sub-program called the National Export Initiative runs seminars in United States cities to offer support and encouragement to United States exporters. It started in February 1991.

In addition to the Federal programs, the State Governments collectively spent $US92m ($A118m) on trade development in 1990, employed 900 people and operated over 160 offices world-wide (Friedman 1991). Every State now operates some kind of trade development program and expenditure on these programs has been growing rapidly. The Port Authority of New York (1988, p. 6) estimated 1987 expenditure of this type as around $US294m ($A420m). Of this, almost $US173m ($A250m) was on agricultural exports; this represented $5.95 for every $1000 of agricultural exports, compared with 54c for each $1000 of industrial exports in that year. Assistance was provided through counselling and education of exporters, trade fairs and exhibits, provision of information to potential customers and start-up measures.

Export finance

The Government provides export finance assistance for manufactured goods through the Export-Import Bank of the United States (Eximbank); and for agricultural goods through the Department of Agriculture's Commodity Credit Corporation (CCC). Eximbank provides loans and guarantees in accordance with the OECD Arrangement on Export Credits, while CCC provides short and intermediate-term export credit guarantees which are used in conjunction with commercial financing.

Eximbank

Eximbank was chartered in 1934 as an independent government agency. It finances some United States exports by providing loans, guarantees, and insurance support. Eximbank's direct credit loan programs are said to be used primarily for transactions facing officially supported export credit from competitor governments to neutralise the competitive effect of such financing. Eximbank's major role is in providing guarantee or insurance support for transactions where private financing otherwise would not be extended due to excessive political or commercial risks.

Table XI.2: **United States' Eximbank's activity: 1989 and 1990**
(1990 $Am)

Authorisations	*Fiscal 1989*	*Fiscal 1990*
Long-term loans	689	376
War chest	0	68
Medium-term loans	269	337
Other	0	3
Total loans	958	783
Long-term guarantees	1161	3571
Medium-term guarantees	489	680
Working capital guarantees	73	114
Insurance	5789	6196
Total guarantees and insurance	7511	10561
Total authorisations	**8469**	**11343**

Source: Trade Finance, January 1991, p. 29

Eximbank does not have any appropriated funds (other than the `War Chest' discussed below) and has no access to any other special funds. In essence, it is authorised to operate through the private banks (in the form of the Private Export Funding Corporation) and the Foreign Credit Insurance Association.

In fiscal 1988, Eximbank's statutory loan ceiling amounted to $US690m ($A957m) and its guarantee and insurance ceiling to approximately $US14.6b ($A20b). Eximbank used the entire $US690m in loan authority and approximately $US5.7b ($A7.9b) in guarantee and insurance authority. These amounts were associated with approximately $US6.5b ($A9b) in United States exports.

Australia's EFIC told the Commission that, in comparison with its international competitors, Eximbank's losses on insurance were low. In the period 1984 89 they amounted to a total of US$350m, compared with France's CoFACE loss (the worst case) of US$5.2 billion (Sub. 28, p. 4).

Mixed credits

In addition to standard export credit activity, Eximbank occasionally extends mixed credit support for United States exports. Mixed credits are generated by combining standard export credit with grant resources from a special fund.

In October 1986, Congress authorized a two-year, $US300m ($A444m) `War Chest' mixed credits program, ostensibly to bolster the United States' leverage for negotiations in the OECD on mixed credits. Subsequently, Congress appropriated $US100 110m ($A150 160m) for each of fiscal years 1987, 1988 and 1989.

Prior to successful negotiation of the OECD's mixed credit agreement in March 1987 (which is discussed in Volume 1, Appendix E), Eximbank used the `War Chest' to initiate mixed credit offers in markets traditionally dominated by countries unwilling to negotiate a new agreement. According to the United States Government's contribution to the GATT Trade Policy Review, the successful conclusion of the 1987 OECD agreement resulted in a shift in Eximbank's usage of the `War Chest' from being an offensive to a defensive tool. Eximbank used its resources to police the agreement. This resulted in few new mixed credit transactions, because most such credit offers conformed to the agreement.

However, EFIC told the Commission (Sub. 28, pp. 6-7) that the United States Government resumed its mixed credit program in 1990, responding to its lack of success in limiting mixed credits within the OECD group of export credit agencies. It has targeted soft loans aggregating $US125m (around $A160m) to each of four countries -- Indonesia, Pakistan, Philippines and Thailand. The aim is to help United States exporters in selected industries including power plant engineering and construction, telecommunications, pulp and paper.

The reversion to a more offensive (rather than defensive) role for Eximbank is apparent also in the Bank's 1990 annual report to Congress:

> for cases for which Eximbank offered financing, no exports have been lost over the past two years due to standard official export credit competition from competing agencies of other countries. In addition, the Bank has successfully implemented several innovative financing programs ... which not only expand Eximbank's ability to provide competitive financing, but also increase exporter opportunities to sell to private sector buyers in LDC markets...
>
> Tied aid is the primary area where both empirical evidence and exporter comments indicate a significant competitive problem. In an effort to restrict its use, the Bank has pursued a three-pronged strategy [entailing negotiations within the OECD], aggressive initiation of tied aid/mixed credit offers in problematic markets and sectors, and matching of competitors' offers if they violate internally agreed upon rules, and the implementation of tied aid facilities in strategic developing country markets (Eximbank 1991, covering letter).

Tax incentives or concessions for export

The United States Government's most important (perhaps its only) current tax incentive to encourage exports is a device known as the Foreign Sales Corporation (FSC). This replaces an earlier device, `Deferral of Income of Domestic International Sales Corporations' or DISCs, which fell foul of GATT rules in 1984.

Kodak (Australasia) Pty Ltd told the Commission that the FSC program took advantage of the GATT principle that:

> an exemption from tax on export income is permitted only if the economic processes which give rise to the income take place outside the borders of the country granting the exemption. In light of these rules, the legislation provides that a FSC must have a foreign presence, it must have economic substance, and the activities that relate to the export income must be performed by the FSC outside the US customs territory. To qualify as a FSC, a company must be incorporated in a United States possession (excluding Puerto Rico) or in a foreign country which has been certified by the United States Treasury Department to have an acceptable exchange of information agreement with the United States. Many United States corporations, including the Eastman Kodak Company, have selected the US Virgin Islands as the site of their FSCs. (Sub. 29, pp. 4-5)

An FSC is a specially established foreign corporation, located outside the United States Customs territory. The tax incentive provided by the FSC legislation is a permanent exemption from federal income tax for a portion of the export income attributable to the offshore activities of the FSC. Information from the United States Department of Commerce suggests that after-tax profits on export sales can be increased by 7.3 per cent (and perhaps a little more). The Department notes that because of the United States tax laws, most FSCs are incorporated in the United States Virgin Islands and Guam.

The actual legal requirements to establish an FSC are quite complex, not from the point of view of protecting shareholders or creditors of the company, but to establish some sort of legitimacy under GATT rules. Wayne S. Kaplan, a United States tax lawyer and commentator notes:

> Clearly, if the GATT considerations that inspired the FSC were not to be forgotten, the regulations had to convey more than a superficial appearance of substance and enforceability ... Several years from now we may know whether GATT has found a conceptual inconsistency in this system ... Based on the prevailing scuttlebutt, taxpayers are assuming that an office qualifies if it has four walls, if it does not roll, float, or fly, and if nothing happens there except for occasional forklift deliveries of financial statements and invoice-related documents (Kaplan, pp. 207, 205 and 217).

Details on the costs to United States revenue of this device are not readily available.

Research and development

The general policy of the United States towards commercial R&D is that it should be financed by the private sector. Nevertheless, the Government sees a role in supporting basic research. It also funds research aimed at special sectors, especially defence, health, energy, the environment and space.

The United States budget for 1990 provided $US67b ($A86b) for R&D. Of this, 52 per cent was to procure R&D services from industry, 24 per cent went to various government agencies and 13 per cent to universities and colleges. An additional $US2b ($A2.6b) was to be provided in 1991.

Much of this funding was for expenditure under Defense and NASA programs. The Commission has no information to suggest what share might be linked with exports. The following from the EC (1991, p. 5) is of interest:

> A further issue of concern related to technology, is the significance of US Department of Defence spending in support of Research and Development. Much of the ensuing technology has applications in the purely commercial sphere, as well as that of defence. Such support represents an effective indirect subsidisation of commercial production.

Commercial spending on R&D attracts no special taxation treatment other than that it may be treated as current expenditure.

XI.4 Effects of the United States export enhancement measures

Effects on the United States economy

The Commission found very few empirical studies of the effects on the United States of its export enhancement measures. Most attention has been given to the agricultural support policies (and that often by Australian researchers).

ABARE concluded in 1989 that the effects of the EEP on the fortunes of United States wheat exporters were much less than commonly believed:

> Most of the increase in US exports that can be associated with the EEP would have occurred if the same volumes that were released as bonuses had been released in a non-discriminatory manner ... It is estimated that, in 1987 and 1989 combined, the EEP increased US exports of wheat by some 11.5 Mt -- but that some 8 Mt of this would still have been exported if the same volume of stocks had been released in a non-discriminatory manner. The recovery in US market share between 1985-86 and 1988-89 resulted primarily from the real US dollar depreciation, lower loan rates and the EEP, which together outweighed the effect of substantially increased protection by competitors (Roberts *et al* 1989, p. 9).

This small gain in export markets that is probably attributable to the EEP must be offset against the costs to the United States consumers and taxpayers of the support provided. A recent United States study has concluded:

> the United States stands to lose welfare as a result of targeted export subsidies ... The result that the welfare of the subsidizing country falls as the share of the subsidized market increases argues against expansion of current programs. The growth of export subsidy programs over the past few years has been at the expense of national welfare (Bohman *et al,* 1991, p. 701).

The annual reports of the TDP and of Eximbank both point to successes in attracting orders to United States exporters, but provide no clear discussion as to whether the benefits have been sufficient to offset the costs. As an example of this, exports claimed to be associated with projects for which TDP provided assistance increased in 1990 by US$400 million to more than US$3.2

billion since the program began in 1986. While the TDP's annual report relates its spending to United States exports, it provides no analysis to demonstrate any causation. In most cases it seems the program has not achieved its aim -- the US$3.2 billion is out of an estimated total export market for the projects sought of US$21.4 billion (TDP 1991, p. 53).

Eximbank too appears to judge its success in terms of the share of cases won or lost in the face of international export credit competition. For 1990 it reported that it won almost 90 per cent of the cases in which it was involved. It also surveys its customers to gauge their satisfaction with Eximbank service. The reported results are all in terms of how Eximbank is perceived as a competitor for other countries' export credit agencies. There is no analysis of the effect on profitability or employment at the firm level, let alone at the level of the general economy (Eximbank 1991).

At this stage, it seems likely that the intimidatory tactics employed by the United States under Section 301 and similar provisions may have resulted in a beneficial expansion of United States exports and opened new markets for United States exporters. This may have been offset to some extent by the higher barriers to imports into the United States that these provisions have raised.

The FSC arrangements, whilst seemingly a major incentive, operate only to reduce the tax payable on profits earned in export markets. They are unlikely to have much effect on the prices offered by United States exporters. They may, however, have the effect of encouraging exporters through the provision of a supportive tax structure.

Effects on the Australian economy

The United States policies associated with agricultural trade have definitely been to the detriment of Australia.

> Upper estimates of the direct cost to Australian wheat producers resulting from the price discrimination component of the EEP, for 1987 and 1988 combined, are between US$150m and US$238m. These costs result from reduced average prices on Australian exports, and from income foregone (relative to that obtainable from alternative enterprises) as a result of the consequent decline in wheat production. It is estimated that in 1987 88, Australian production of wheat fell by between 0.7 Mt and 1.0 Mt as a result of the price discriminatory element of the program in the previous year (Roberts *et al* 1989, p. 8).

The Commission received submissions from several agricultural interests in the canned fruits, dairy and rice industries pointing out that their markets were reduced by United States import barriers and their returns affected by United States subsidies and targeting of markets.

The Canned Fruits Industry Council of Australia told the Commission that over the six years to 1991 the United States had provided targeted export assistance of $US26m ($A33m) to help promote sales of canned peaches and the like in Pacific Rim countries. Other assistance had helped United States canners gain markets in Canada and Japan. Each of these areas had been important outlets for the Australian industry. Together these programs had severely threatened the Australian canners and growers (Sub. 5, pp. 3, 5).

The Ricegrowers Co-operative Limited said it had found its markets in Turkey targeted `with an EEP of US$36 per tonne, which has disrupted this market and is causing us significant loss' (Sub. 15, p. 2). The Co-operative observed that subsidy competition between the EC and the United States had led Thailand to increase support for its rice exporters, once again putting pressure on the Australian industry.

Bohman *et al* (1991, p.701) concluded:

> This paper also demonstrates why exporting ... countries have objected so strongly to subsidy programs. The EEP was originally designed to punish the EC for their export subsidies ... The US Department of Agriculture claimed that other exporters would not be damaged. However, Canada and Australia immediately recognized the US export subsidies adversely affected their terms of trade. Their complaints are supported by the results of this model.

If the United States is successful in forcing the EC to reduce CAP subsidies, Australia could benefit greatly in the longer term, as it seems Australia is a lower-cost producer than the United States of many of the products in dispute.

XI.4 Concluding comments

The United States Government's push to open export markets has resulted in some real and some potential gains for Australia. Australia should be able to benefit from the opening of markets particularly in the Asia/Pacific region. Indeed, it has already done so in the Japanese and Korean beef markets, for example. More generally, the United States has forced the liberalisation of trade policies in many countries and encouraged greater adherence to the GATT Subsidies Code, all of which benefit third countries.

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XII THE EUROPEAN COMMUNITY

The European Community (EC) presently comprises 12 nations -- Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and the United Kingdom[1]. It has not been possible for the Commission to study the export enhancement measures employed by every member state. Instead, this section focuses on the Community as a whole and the three that follow examine the Community's largest constituent economies: France, Germany and the United Kingdom.

The EC has several programs which affect export enhancement. First, it controls the trade policy of member states. It polices GATT proscriptions against the use of export subsidies and has the authority to curtail export enhancement activities of its member states, if they can be shown to be detrimental to other member states. The EC operates the Common Agricultural Policy (CAP) which includes extensive use of direct and export subsidies of agriculture in the member states. The EC funds research and development programs to enhance international competitiveness. As well, the EC has begun to act against payment of large state subsidies to industries in member states.

XII.1 Trade performance

Since the signing of the Treaty of Rome, the proportion of world trade accounted for by trade between member states has almost doubled, rising from 23 per cent in 1958 to 38 per cent in 1989. Although the EC's external trade is less significant than trade between member states, it is still of importance. The Community's largest trading partner is the United States, followed by Austria, Sweden and Switzerland. As a group, EFTA countries (Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland) bought almost a third of Community exports and were the source of more than a quarter of imports.

There is considerable diversity in the trade patterns of member states. For example, in 1988 automotive products ranked highest in the export lists of Germany and Spain, while food products were the chief export earners for Denmark, France, Greece, Ireland and the Netherlands. Import patterns show a similar diversity.

The EC collectively accounts for approximately a quarter of world GDP. The major part comes from the services sector, which contributes about two-thirds of Community GDP, followed by manufacturing industry (one-third) and agriculture (around three per cent).

[1] Australia and Sweden have applied for membership. There are also pans to create a European Economic Area comprising the EC and the European Free Trade Association (EFTA) membership states.

XII.2 Trade and industry policy

The EC operates as a customs union, which to an extent unifies the policy stances of member countries in relation to external trade. The EC's trade policies have resulted in wide discrepancies in the levels of assistance available across industries. Coal and steel are regulated separately, as part of a framework established prior to the signing of the Treaty of Rome. Agriculture has a special status, and has been the focus of most international attention (see Box XII.1). Other sectoral programs have evolved over time as a response to structural adjustment pressures.

Box XII.1: **The Common Agricultural Policy**

The CAP has effectively isolated European farmers from the realities of international competition. The EC has moved from being one of the world's largest importers of temperate zone produce to being the second largest exporter in 1985. By 1987, the EC was the largest exporter of sugar, the third largest wheat exporter and the dominant supplier of dairy products.

The policy's price management system relies on three main instruments. Variable import levies ensure that imports do not undercut the price of domestic goods. Export subsidies also are used. Finally, intervention purchasing agreements ensure that any oversupply of commodities does not cause prices to fall below the negotiated levels.

The OECD has calculated that the CAP's producer subsidy equivalent (PSE) was $US64b ($A82b)[2] in 1990, equal to 48 per cent of the value of agricultural production. This level marked the continuation of a trend towards ever higher subsidy levels in the EC since the 1970s. (The PSE level for Australia was 11 per cent, and those for the US and Japan were 30 and 68 per cent respectively.) The CAP and the United States' Export Enhancement Program (EEP) have caused severe losses in returns and market share of Australian wheat exporters.

In response to the CAP's escalating costs, adverse environmental consequences of intensive farming practices and concerted international pressure, there have been moves toward reform. In 1992, member states were again grappling with a package of measures to reform the CAP. Earlier efforts to reform the CAP have not prevented over production.

[2] $A estimates used in this report are expressed in terms of 1990 Australian prices.

Subsidies other than to agriculture have been provided primarily by member states. According to the EC Commission, subsidies for the steel and shipbuilding sectors in particular have been reduced over the past decade. The EC Commission has adopted a more aggressive stance against subsidisation of industry although there is continuing resistance from some member states.

Institutional framework

Under the Treaty of Rome, the EC Commission has responsibility for the initiation of common policies and legislation. It co-operates with the other major bodies of the institutional structure of the EC, the most important of which are:

- the Council of Ministers, which is made up of government ministers from Member States, and is the main decision making body of the Community; and

- the European Parliament, which is composed of directly elected members and shares budgetary authority with the Council of Ministers, and also has a legislative function.

The Commission submits policy proposals for approval to the Council of Ministers, which can veto them. The EC is responsible for overseeing the implementation of agreed policies. Trade policy decisions are often made de facto as a result of sector specific meetings by the Council, in such areas as agriculture. The GATT Secretariat (1991, vol. 1, p. 8) considers that EC trade policy is characterised by sector-specific solutions. The European Parliament's influence on trade policy is limited to an advisory role.

XII.3 Export enhancement measures

The EC has limited powers over export promotion activities; instead individual member states engage in programs on their own behalf. However, the Treaty of Rome outlaws any aid granted by member states that distorts intra-EC trade.

Export subsidies

The EC does not provide direct export subsidies to manufacturing. However, as discussed above, there are a number of sector-specific subsidies at the national level. The CAP is considered briefly in Box XII.1.

Tax incentives or concessions for export

All EC member states allow VAT rebates for exports. Exports to other EC countries are thus taxed at the country of destination's VAT rate. The 1992 single market plan will change this and exports within the EC will be subject to country of origin taxes. This would create a `seamless' market, and shift VAT revenues towards exporting countries (Economist 15 June 1991, p.86).

Research and development

The EC sponsors a range of `pre-competitive' research and development initiatives to promote the international competitiveness of European industry. These programs are additional to significant national programs in place in most member countries.

To obtain EC funding, programs must satisfy several `Community dimension' criteria. For example, they must:

- avoid duplication and consequent wastage of resources between countries;
- problems must be community wide;
- activities must be of a sufficient scale; and
- programs should be consistent with broad Community policy.

There is no formal statement of export promotion as an objective of these programs, although such an objective is perhaps implicit. In practice, these guidelines mean that Community funding is available to international collaborative projects, partly funded by industry, with participants from universities and other organisations across Europe.

The EC gives particular attention to the information technology and telecommunications sectors, and has targeted them as `essential' to future European international competitiveness. These sectors have felt the keenest competition from Japanese and American firms. The EC's trade deficit in electronics has doubled over the past four years. The French Government in mid-1991 was disputing the European Commission over its planned increase in subsidies to its state computer companies, Groupe Bull and Thomson (Newsweek 22 June 1991, p.64).

A plethora of R&D programs are directed at these and other sectors. The following are the most significant:

- Research and Development in Advanced Communications Technologies in Europe, with a cost of 550 million ECU (about $A850 million) over five years;
- European Strategic Program for Research and Development Information Technology, with a budget of 750 million ECU (about $A1150 million) over five years; and
- Basic Research in Industrial Technologies for Europe/ European Research in Advanced Materials, with a budget of 440 million ECU (about $A680 million) over four years.

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XIII FRANCE

France was one of the six original signatories of the 1957 Treaty of Rome which established the European Economic Community. France's principal trading partners are other members of the European Community.

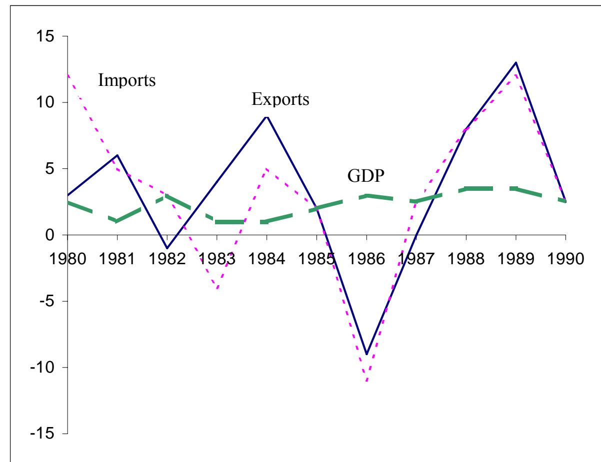
XIII.1 Trade performance

The growth of GDP and trade is illustrated in Figure XIII.1. France's GDP is about four times that of Australia and its per capita GDP 14 per cent higher than ours.

The composition of manufactured exports in 1988 is shown in Table XIII.1. Manufacturing in 1988 accounted for 21 percent of GDP, but 78 per cent of exports. In the same year agricultural and manufactured food products together accounted for 7 per cent of GDP, while exports of such goods made up 16 per cent of all merchandise exports.

Most of France's exports go to other EC countries (64 per cent of all exports in 1988). France's major export markets are illustrated in Figure XIII.2.

Figure XIII.1: **France's growth in GDP and trade: 1980-90**
(Constant prices percentage change)



Source: OECD 1991, p.87

Table XIII.2: **Merchandise exports from France: 1988**
(Per cent)

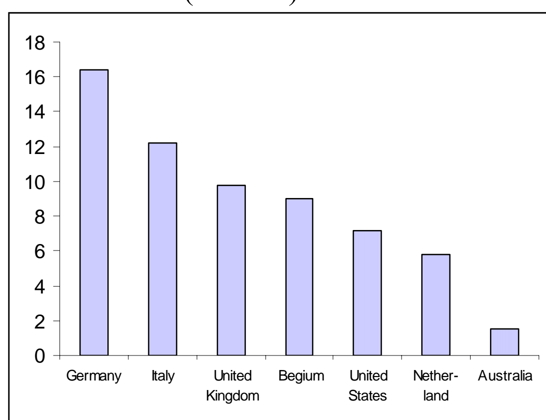
Machinery and transport equipment	35
Other manufactures	28
Chemical products	15
Food, live animals	12
Crude materials (except fuels)	4
Beverages and tobacco	3
Mineral fuels etc	2

Source: OECD 1990b, p.142

XIII.2 Trade and industry policy

Since 1946, the modernization and expansion of capital facilities have been carried out under five-year economic plans which establish a general framework for economic, social and cultural objectives. The most recent plans have been aimed at reducing public funding of heavy industry and concentrating public support on new, high-technology industries, with basic and applied research receiving major emphasis. In 1986 the French Government began to privatise nationalised banks, insurance, computer and industrial companies. Compared with other OECD countries a higher percentage of the French economy is state owned.

Figure XIII.2: **Major destinations of France's exports: 1988** (Per cent)



Source: OECD 1990b, p.143

France has a longstanding public preoccupation with exports, a strong consensus favouring government intervention in the economy, widely held beliefs about the desirability of achieving economies of scale through the building of large, export-oriented enterprises, and a political emphasis on its relations with developing countries in general and its French-speaking ex-colonies in particular. It maintains some special relationships with its former colonies, particularly in the economic sphere.

In recent years, persistent French trade deficits may have played a particularly important policy role, as they have frequently been cited as the chief obstacle to sustained national economic growth. This perception, coupled with a highly centralised form of government, has resulted over time in one of the world's most expensive and comprehensive systems of officially supported export financing. Although changes in Governments have brought about certain shifts in policy during the current decade (and state intervention in the economy has declined somewhat), there has been no effective challenge to the basic tenets of French aid and trade policies (Eximbank 1989).

French trade and industry policy is increasingly dominated by obligations and issues arising from membership of the EC. French trade policy interests are represented internationally by the EC which acts on behalf of all EC member states on trade matters. Industry policy is increasingly

being influenced by EC obligations. As part of the program to develop the EC Single Market, the EC Commission has intensified pressure on member states to reduce the incidence of general subsidization of industry and to increase competition inside the EC.

France is a strong supporter of greater integration of the EC. But it has been a consistent opponent of policies to reduce protection and subsidisation, not least in agriculture.

XIII.3 Export enhancement measures

Apart from its involvement in the CAP, France's major export enhancement measures relate to export credit and export promotion -- see Table XIII.2. The budgetary cost of French export enhancement measures in 1991 is estimated at around 0.4 per cent of GDP -- or about 2 per cent of total export revenue. Spending on these measures in 1991 was expected to be 16 per cent higher than for 1990.

Table XIII.2: **Budgetary costs of French trade incentives: 1985, 1988 and 1991** (1990 $A million)[1]

	1985	*1988*	*1991*
Export promotion	438	540	264
Export finance assistance:			
Government Development Assistance			
Treasury loans	813	715	1 101
Guarantees -- see page 165			
export credit insurance	565	2 933	1 828
exchange rate cover	(443)	(8)	-
Sub-total	123	2 925	1 828
Export Credit Support -- see page 166			
Bank of France rediscounts	1 160	279	274
Banque Française du Commerce Extérieur	945	284	457
Consolidations -- see page 166	161	789	2 353
Sub-total	2 267	1 351	3 084

Notes: Figures shown in brackets are credits.
Source: French budget papers

1 $A estimates used in this report are expressed in terms of 1990 Australian prices.

Export subsidies

Airbus is being manufactured by a four-nation European civil aircraft consortium. Since 1967, direct French support to Aerospatiale for Airbus related projects has been estimated at $A4.6 billion (USTR 1990).

The shipbuilding industry is supported by a subsidy program. This has been reducing from 35 per cent of contract price in 1986 to 13 per cent in 1991. There are a number of other (small) programs to help small and medium sized businesses, especially with adjustment and innovation programs. None of these appears to be an explicit export subsidy, but it is likely that some (especially that to shipbuilding) finds its way into exports.

Assistance through the CAP is very important to French agriculture and finds its way into many processed farm products. In recent years there have been a number of countervailing duty cases against such EC produce as pasta and ham. Australia has imposed countervailing duties against imports of French brandy because of subsidies provided through the CAP.

Export marketing assistance

The *Compagnie Fraçaise d'Assurance pour le Commerce Extérieur* (CoFACE), established in 1946, is a semi-public joint stock company to promote the export of goods of French origin. Its main activity is export insurance (see below) but it also provides market development assistance.

Exporters develop an overall budget for market development in co-operation with CoFACE. Each year of the policy CoFACE will pay a provisional indemnity equal to a percentage of the costs the company has agreed to undertake in market development if revenue is not enough to cover those costs. Eligible costs include those for market studies, visits, publicity, local stocks, participation in displays, engaging a local agent, adaption of the product and creation of an export division. The provisional indemnity is repayable in accordance with sales achieved in the target market.

In 1983 the Ministry for Trade and Small Manufacturing Industries set up the *Fondation ā L'Exportation Artisanale* to help small manufacturing industries, especially in their attempts to export. In the beginning the Government provided all the funding. This has now dropped to around 20 per cent with the balance coming from industry, especially from larger companies. Much of this is in kind, such as cheap airfares from French airlines.

Export finance

France has a complex of institutions and programs to assist in providing export finance. These can be divided into two areas:

- mixed credits granted under bilateral agreements known as `protocols'; and
- subsidised commercial activity.

Associated with these are arrangements to subsidise insurance against various trade risks.

According to Messerlin (1986, p.387), the origin of France's export credit arrangements lies in its colonial past.

> until the mid-1960s, French equipment enjoyed a high level of protection in its export markets, which were mainly French colonies ... the French economy needed to import those investment goods that domestic firms were not able to produce at competitive prices ... tariffs to protect the French domestic market were considered inappropriate ... What was needed was protection of French equipment in other markets. Hence French producers of equipment tended to use colonial markets as substitutes for lost domestic markets.
>
> The high level of protection in colonial markets disappeared progressively ... subsidised export credits appeared to be a perfect substitute for the old colonial system of protection because the same industries as before received a level of protection similar to that granted previously, but now on a worldwide basis.

Messerlin adds that this tendency was reinforced by the traditional mercantilism of French officials and businessmen.

Mixed credits

France is widely recognized as the originator of mixed credits, the blending of foreign aid funds and export credit. The principal institutions involved in French mixed credits are the Direction des Relations Economiques Extérieures (DREE) and the Treasury, separate divisions of the Ministry of the Economy, Budget and Finance. These bodies make policy in this area, with the Treasury also providing the concessional funding component of the mixed credit.

Mixed credits are provided through Treasury loans and grants. These are extended to developing countries having a *per capita* GNP of US$2000 or less. The funds are used predominantly for financing projects in the energy, telecommunications, water, health and manufacturing sectors. The funds are provided within the framework of protocols between the French Government and the recipient country and are generally associated with private sector export credits guaranteed by CoFACE (see below).

Protocols are generally entered into annually and establish the aggregate amount and financing terms available to the recipient country for multiple projects. Most protocols combine concessional Treasury loans with officially guaranteed commercial export credits. Generally the loans have interest rates of between 2 and 3 per cent and a duration of 15 to 30 years with grace periods of between 3 and 13 years.

As part of a general effort to reorient French exports, particularly large infrastructure contracts, towards markets with greater potential for ongoing commercial activity, there has been a greater tendency to restrict the use of Treasury loans to the most solvent markets. A corollary has been the increased use of grants to the poorest countries. These grants are also used to fund emergency aid and costs associated with food aid.

* * *

A key characteristic of French mixed credits is their sectoral composition. Consistent with the argument that infrastructure projects represent an efficient use of development assistance, French mixed credits appear to be concentrated in those industrial sectors related to the provision of infrastructure. Thus, the principal sectors benefiting from mixed credit financing under protocols are, in decreasing order of magnitude: transportation, electricity generation, and telecommunications.

The United States' Eximbank is in no doubt that France's mixed credit facilities have export promotion as a major objective:

> The institutional framework responsible for the mixed credit system attests to the fact that export promotion is a principal objective of the system. The DREE, which is the primary vehicle for channelling development assistance to countries that are not former French colonies, is first and foremost the key player in French foreign commercial strategy and manages that country's export credit mechanism.
>
> The DREE, unlike US A.I.D., Britain's ODA, or Germany's Ministry of Economic Cooperation does not provide bilateral development assistance to all eligible developing countries, including the poorest. Rather, the DREE's mixed credit protocols are directed to the `non-CCCE' countries and represent by far the dominant form of French bilateral assistance to those countries (Eximbank 1989, p.53).

US Eximbank officials assert that, in recent years, budgetary pressures have begun to affect the mixed credit program. They argue that two separate but related phenomena have been in operation. First, successive increases in the minimum concessionality element required by the OECD Arrangement and changes in the calculation of this element have increased the real cost of the practice. Second, they maintain that the French Treasury's success in increasing the transparency of French export subsidisation in the budget has constrained the growth of the mixed credit program. In effect, the Treasury appears to believe that its policy of highlighting the budgetary costs associated with mixed credits has prevented even greater expenditures for this purpose (ibid., p.54).

In addition to increasing the concessionality level of the credit, the relatively greater share of the Treasury loan in the mixed credit package appears to reflect the Treasury's policy of favouring Treasury loans (a budget line item) over guaranteed export credits (not a budget item) as a means of drawing attention to the cost of the program.

The heavy use of mixed credits by France relative to other countries is indicated by the figures in Table 5.6 in Volume 1.

Commercial transactions

Export insurance

Depending on the circumstances and on the risks involved, CoFACE acts either on its own account or on behalf of the government insuring loans made to foreign purchasers of goods from France. Creditors may insure against political, commercial, foreign exchange, and/or catastrophic risks. CoFACE generally covers short-term commercial risks (credit up to three years) on its own behalf. All other risks are covered on behalf of the government. CoFACE has no legal monopoly and faces some commercial competition (OECD 1990a).

CoFACE offers coverage against unforeseeable increases in production costs during the manufacture of goods under contract. In 1989 more than half of the guarantees given concerned the aeronautics and space, electronics and electro-mechanical industries. Table XIII.3 shows the extraordinarily poor ratio of premiums received to indemnities paid.

Table XIII.3: **Economic risk coverage by France's CoFACE: 1987-90**
(1990 A$ millions)

	1987	*1988*	*1989*	*1990*
Net indemnities	286	449	204	39
Premiums collected	50	87	13	na
Balance	-235	-362	-191	na

na not available
Source: French budget papers

France is currently paying for the too liberal use of export credit in the early 1980s to encourage export growth. From Table XIII.2, more than one-fifth of the 1991 foreign trade budget was allocated to cover obligations incurred by CoFACE as the result of the failure of other countries (primarily Poland, Nigeria, Morocco, Egypt and Brazil) to pay their debts to French companies. A similar share was allocated for export credit insurance in the 1991 budget.

In order to avoid a worsening of this problem greater care is being taken, through the more restricted use of export credit guarantees and other mechanisms, to encourage French exporters to look towards more solvent markets for their sales.

CoFACE also provides guarantees against exchange rate loss. The objective is to enable exporters to quote and sell in foreign currencies without exchange rate risk. After achieving surpluses in 1985 and 1986, CoFACE now aims to break even on this facility.

France has made large losses on its export insurance and guarantee activities as indicated in Table 5.2 (Volume 1).

Subsidised credit for normal commercial exports

The *Banque Française du Commerce Extérieur*, a government-owned bank, takes the lead in providing the `commercial' (including OECD Arrangement-rate) financing of exports, working closely with CoFACE and the commercial banks. Once again, DREE and the Treasury are the principal government agencies involved in the policy-setting bodies. The line in Table XIII.2 relating to BCFE support covers:

- pre-shipment credit -- this is available to exporters of heavy equipment, to finance their costs during the manufacturing period, at a fixed interest rate which is between the money market rate and the credit rate (net bank charges). It is apparently little used.

- progressive payments -- bridging credit can be provided through progressive payments during the period from when the exporter first uses the credit until the commencement of repayment upon finalisation of the exporter's contractual responsibilities.

- stabilisation of bank credits (medium and long term):

  ---- for credits in francs: compensation is given for the difference between the credit rate and a representative inter-bank rate; and

  ---- for foreign currency credits: compensation is given for the difference between the credit rate and the Paris inter-bank refinancing rate for foreign currencies.

The heading `consolidations' in Table XIII.2 relates to the costs of consolidating unpaid commercial debt by BCFE and unpaid Treasury loans. These costs made up 35 per cent of the estimated total budgetary cost of export support in 1991.

Tax incentives

The tax on corporate profits in France is 42 per cent. Value added tax is the prime source of tax revenue but is not payable on exported goods.

Export related investment measures

Investments to increase export capacity can benefit from long term loans at reduced interest rates, subject to the conditions that a company's turnover does not exceed 500 million francs and it is not controlled by a company with a turnover higher than this figure. Loans are available to:

- manufacturing companies which invest to increase their export capacity for non-EC markets;
- sub-contractors to exporting companies;
- companies which export through a separate trading company; and
- engineering and consulting firms.

Research and development assistance

In 1986, for non-military, high-tech R&D, the Government contributed 57 per cent of the total (approximately the same amount spent in the United States and United Kingdom but much lower than that spent in Japan and Germany) and private enterprise contributed the balance.

Several Government subsidies are available. There is a 50 per cent tax credit on annual increases in R&D expenditures apparently available to all enterprises. In addition, there are a number of targeted programs:

- grants of up to 50 per cent of R&D and investment costs in energy saving technologies for selected projects in particular regions;
- up to 50 per cent of R&D costs through a special fund for oil technologies; and
- direct and reimbursable grants of 30-40 per cent of the R&D costs of electronics companies.

Government equity

France has several exporting companies which are, in part, publicly owned. Where government does not demand a market rate of return on its investment, this equity participation by the public sector can confer a special benefit. Direct subsidies to such businesses are scrutinised by the European Commission: it has been reported that France is subsidising producers by having state-owned banks buy equity (*Economist,* 1991, p.19). The *Economist* reports that this is occurring in the case of Air France and Usinor Sacilor, a steelmaker wholly owned by the state.

XIII.4 Effects of export enhancement measures

The costs to the French populace of support to the agricultural sector are now well documented (see chapter 4). Less is known about recent effects of its export finance policies. Melitz and Messerlin (1987) reported that by the 1980s, export credit subsidies were of the order of 0.5 per cent of France's GNP. In the case of interest rate subsidies, they concluded that the subsidies were heavily channelled into just a few industries, with many other sectors penalised as a result of export credit subsidisation policies. Their results are summarised in Table XIII.4.

Table XIII.4: **The incidence of export interest subsidies in France: 1981-84**

Industry Sector	*Aided exports as % of all exports* [1]	*Subsidies as % of eligible exports* [2]	*% share of total subsidy* [3]
Strongly aided			
Machine tools	47	11	27
Electrical equipment	54	8	20
Metalworking	50	10	8
Aircraft, Ships	84	4	12
Construction	100	4	15
Ambiguous			
Services	27	9	6
Autos	28	5	8
Iron, steel	29	3	2
Oil	16	2	1
Agroindustry	36	2	2
Rubber, plastics	25	2	1
Heavy chemicals	20	1	1
Hurt			
Coal	-	0.5	-
Printing	-	0.4	-
Nonferrous metal	-	0.4	-
Textiles	-	0.2	-
Transport	-	0.1	-
Construction materials	-	0.1	-
Wood-Furniture	-	0.1	-
Paper	-	0.1	-
Other chemicals	-	-	-
Glass	-	-	-
Leather, Shoes	-	-	-
Agriculture	-	-	-
Meat, milk	-	-	-
Hotels	-	-	-
Telecommunications	-	-	-
Electricity	-	-	-
Economy average	*27.4*	*5.4*	-

Source: Melitz and Messerlin 1987, p.162

Column 1 of this Table shows aided exports as a fraction of total exports from that sector. Column 2 shows the rate of subsidy on exports eligible for subsidy. Column 3 shows the distribution of the total subsidy among industry sectors. Melitz and Messerlin observed that a government adopting export credit subsidies would tend to adjust fiscal and monetary policy in consequence. The result would be a higher real exchange rate and higher real interest rates. Those who are subsidised still get relief; others are hurt by the macro policies which accompany export credit subsidies. They estimated that once allowance were made for induced effects on the exchange rate and the impact on non-aided trade, the result for several industries would be ambiguous. Other industries (the third group in the table) would, unambiguously, be hurt.

On the matter of insurance subsidies, Melitz and Messerlin found that construction and allied services received two-thirds of the total benefits.

Messerlin (1986, p.386) concluded that:

> far from benefiting from her mercantilist excesses, export-credit subsidisation wastes France's scarce public resources in the promotion of the wrong industries exporting the wrong products to the wrong markets.

XIII.5 Concluding comments

France is of special interest to Australia as one of the major defenders of the CAP and one of Australia's major competitors in food markets. It has also been a major user of mixed credits as a means of promoting exports of capital goods. This assistance may affect Australian exporters seeking to compete in projects involving transport, electrical or telecommunications equipment.
The work of Melitz and Messerlin referred to above suggests that in the past these policies have imposed considerable costs on the French economy. Since that time, the level of support through these measures has risen (see chapter 5 in Volume 1).

From Australia's point of view there is much to be gained by continuing to press for reform of the CAP arrangements, and reductions in France's use of mixed credits and its subsidies of semi-public manufacturers.

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XIV GERMANY

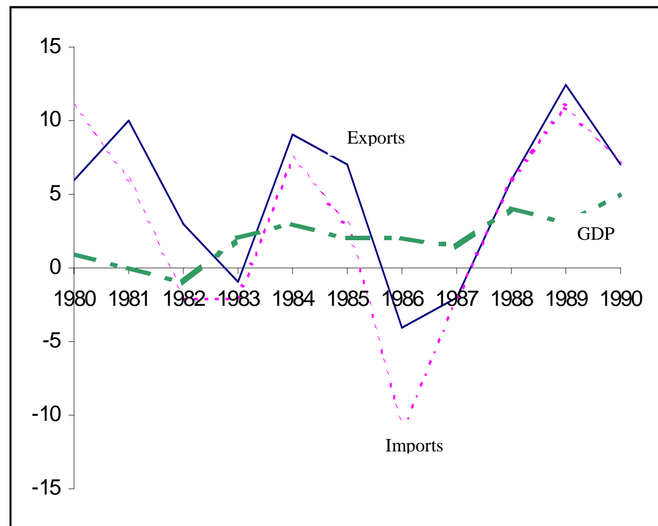
This chapter concentrates on the policies of the Federal Republic of Germany (denoted `Germany' here for brevity) prior to reunification in 1990. Although State policies may affect exports, mainly Federal policies are addressed here.

XIV.1 Trade performance

Despite a substantial decline in the mid 1980s, when there was a major appreciation of the Deutsche Mark of over 40 per cent against the US dollar between 1985 and 1987, export activity increased strongly over the decade -- averaging 4.5 per cent per year (Figure XIV.1).

Manufactured goods are the dominant export of the German economy, having been developed to compensate for the country's paucity of natural resources. Since reunification, demand for German manufactured goods by eastern Germany, formerly the German Democratic Republic, has been strong and more than offset reduced demand in export markets. The OECD (1991, p.128) notes that unification `may have added as much as 1.5 percentage points to output growth in 1990 -- which attained no less than 4.5 per cent -- and another 1 per cent may be expected in 1991.'

Figure XIV:1: **Germany's growth in GDP and trade: 1980-90**
(Constant prices, percentage change)



Source: IMF 1990

Table XIV.1: **Merchandise exports from Germany: 1990**
(Per cent)

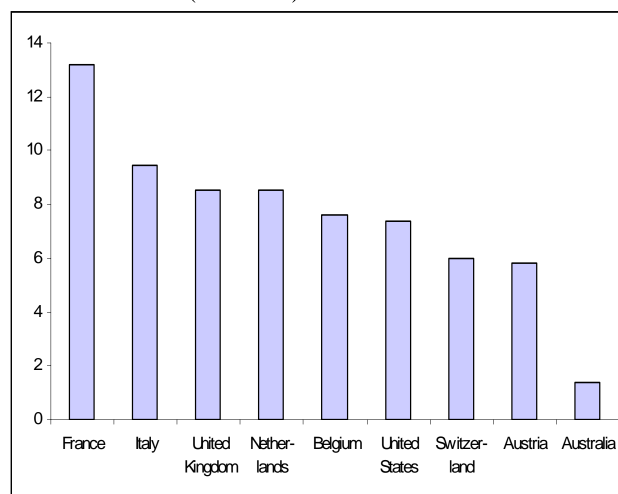
Sector	*1990*
Machinery and transport equipment	49
Manufactured goods classified chiefly by material	18
Chemicals	13
Miscellaneous manufactured articles	11
Food and live animals	4
Crude materials, including fuels	3

Note: Transactions with the former German Democratic Republic are treated as exports in this table.
Source: OECD 1991, p.166

Table XIV.1 shows that machinery and transport equipment dominate merchandise exports. In recent years, the world economy has been introducing new technology at a rapid pace, providing substantially increased demand for German exports of capital equipment.

Germany trades mainly with its west European neighbours with over 70 per cent of exports going to them and the United States accounting for a further 7 per cent (Figure XIV.2).

Figure XIV.2: **Major destinations of Germany's exports: 1990**
(Per cent)



Source: OECD 1991, pp. 164-5

XIV.2 Trade and industry policy

In general, Government trade policy is neutral in the sense that it seeks to promote free trade, does not offer substantial financial incentives and encourages German business to take advantage of market opportunities. However, there are clear exceptions to this rule: the German Government has been increasing assistance to agriculture, coal mining, commercial aircraft and shipbuilding.

German trade and industry policy is increasingly dominated by obligations and issues arising from membership of the EC. German trade policy interests are represented by the EC which acts on behalf of all EC member states on trade matters. Industry policy is also increasingly being influenced by EC obligations. As part of the program to develop the EC Single Market, the EC Commission has intensified pressure on member states to reduce the incidence of general subsidisation of industry and to increase competition inside the EC.

Germany has generally aligned itself with those member states which favour wider application inside the EC of liberal economic policies. A major historical exception has been in the area of agricultural policy where Germany has been a staunch supporter of protection policy.

XIV.3 Export enhancement measures

The Federal and State Governments collaborate with private establishments, chambers of commerce and associations to provide many of Germany's assistance programs. The programs include grants to specific industries, export promotion, export credit, export credit guarantees and R&D, with export credit guarantees accounting for the largest share of budget expenditure in export-related assistance (Table XIV.2).

Table XIV.2: **German Government budget expenditures on export-related assistance, 1986** ($A million in 1990 prices)

Type of scheme	*Level*	*Expenditure*
Grants		
Shipping industry	F	190
Aviation technology	F	318
R&D Grants (mainly towards personnel costs of SMEs)	F	349
Grants and loans to SMEs	S	258
Medium-term export credits deals to developing countries	E	93
Export credit guarantees	E	611

SME Small and medium sized enterprises
F Federal
S States (Laender)
E European Recovery Program
Source: OECD 1990a RESTRICTED Industry Commission estimates

Export subsidies

The Federal Government provides subsidies to the agricultural sector under the EC Common Agricultural Policy (CAP) and to the clothing and textiles industry under the Multi Fibre Arrangement. It also supports the shipbuilding, commercial aircraft and coal mining industries. Under a European Community directive, Federal Government aid to the shipbuilding industry is limited. The ceiling is being reviewed annually.

The Government has provided considerable assistance to the commercial aircraft industry, including grants for marketing support, direct production subsidies and loans for development of the Airbus (IMF 1989, p.45). Other than Airbus, recipients of support for aircraft projects have repaid the funding they received from the Government (OECD 1990). Government subsidies given to the Airbus project have been contentious. The United States is currently disputing this issue with the European Community before the GATT.

The Government has kept the coal industry going by a combination of import restrictions and subsidies. The reasons for this policy range from security (the desire to secure the supply of

energy) to regional policy (the industry is largely concentrated in one area of Germany). Declining demand from the steel industry and general overproduction have caused a large increase in the stockpile of coal. Consequently the Federal and State Governments have implemented a policy to reduce the extraction of coal by 1995. To soften the consequences of this adjustment, in 1987 the authorities promised financial support and agreed to increase subsidised coal exports. Over 1980-87, the Government provided about DM37 billion (about $A34b) in subsidies (both domestic and export) to help the coal mining industry.[1]

Export marketing assistance

Germany's export development and promotion is largely in the hands of the private sector. The government provides some funding support and delivers ancillary services but its direct role in this area is of secondary importance.

The Federal Ministry of Economics is the official German information and contact office for all matters connected with foreign trade. Its German Foreign Trade Information Office (BfAI) promotes trade by providing information and liaising with a network of government offices, chambers of commerce at home and abroad, trade associations and individual firms. Parts of the BfAI's services are run by the Foreign Trade Information Company Ltd (GfA), a Government-owned company operating under private law. Its services include maintaining a comprehensive enquiry and publishing service (Austrade 1990, p.5).

All German chambers of commerce are legally required to aim to break even. They do this by fixing an appropriate membership fee, charging for all services and attempting to secure long-term contracts from German business interests. The percentage of each chamber's costs met by Federal support varies. Austrade noted that the:

> Total operating budget in 1991 of the foreign chambers was approximately DM100 million ($A79 million), of which approximately DM37 million ($A29 million) was provided by the Economics Ministry. ... The Economics Ministry atttaches permanent staff members to six selected foreign chambers for term appointments and meets the costs of these appointments. Economics Ministry staff are also accredited to some German missions and costs involved are covered by the Foreign Ministry (Sub. 42, Attachmnent C, p.17).

Only 3 of 53 Foreign Chambers and Delegate offices were fully self-funded in 1991: the Swiss, Swedish and French chambers. In general, the Government provides more support in developing countries where local membership is minimal.

The Government also covers up to 75 per cent of marketing consultants' costs, depending on the size and nature of the industry involved. However, according to Austrade (1990), most firms prefer to take advantage of the many alternative sources of free advice.

[1] $A estimates used in this report are expressed in terms of 1990 Australia prices.

In addition to subsidising the cost of obtaining market information, the Government provides some support for trade fairs which have a very long tradition in Germany and attract millions of foreigners each year. The Confederation of German Trade Fairs represents the interests of exhibitors, visitors, and fair organisers. As to fairs in other countries, the Government often bears the cost of stand construction and fittings, but exhibitors meet their own expenses. The total cost of official participation in international fairs in 1990 was about DM30 million (about $A24m) (Sub. 42, Attachment C, p.18).

The Port Authority of New York estimated that the German Federal Government spent $US1 ($A1.4) per capita on export marketing, or 10c per $US1000 of GNP in 1987. The Federal government accounted for 60 per cent of funds spent by agencies to assist export marketing -- with State government accounting for 9 per cent, local government 12 per cent and the private sector 18 per cent. Most of these funds are used to provide export information (Table XIV.3).

Table XIV.3: **German export marketing assistance, by major activity: 1987** ($Am in 1990 prices)

Activity	*Spending*
Export information	79
Overseas exhibition support	30
Export counselling/education	18
Business travel facilitation	12
Product advertising support	1
Start-up aids	1
Total spending	**148**

Source: Port Authority of New York 1988, Table 2, p.30

Export finance assistance

German export financing is largely a private concern. Where the Government becomes involved, the terms and conditions of export financing are within the framework of the OECD Arrangement.

Kreditanstalt für Wiederaufbau (KfW)

The KfW (Reconstruction Loan Corporation) is a private company, partly owned by both State and Federal Governments. Its prime goals are long-term investment financing to promote structural adjustment and to finance exports (Austrade 1990, p.13). Small and medium sized enterprises -- with a turnover of less than DM500 million (about $A400m) a year -- are eligible for long-term, low interest loans for expenditure on material and staff for the purpose of trials, production start-

ups, opening new markets and innovative projects. KfW lends through private financial institutions, which have to assume liability in case of default.

Under its Export Financing Program, KfW finances the supply of goods and services (including consulting services) for exports from firms located in Germany and overseas.

The German Finance Company for Investment in Developing Countries (DEG)

The DEG is a Federal Government-owned body which promotes the formation and expansion of German-operated plants in developing countries. It also helps finance partnerships or joint ventures with German companies. Recipients use the loans to finance exports of capital goods at interest rates in line with the OECD Arrangement. The DEG only finances exports with credit guarantees from the Federal authorities and it extends the payment period over four years starting from the date the goods are ready to function.

Export Insurance

Under a Federal Government order, the privately owned Hermes Credit Insurance Company (Hermes) must handle export credit guarantees. Hermes insures up to 70 per cent of the nominal export value. This insurance covers production and country risk which protects the producer in both the pre- and post-delivery stages against loss from political or economic problems in the buyer's country.

Table XIV.4: **Income and expenditure of Hermes export credit insurance system: 1985-89**
($A million in 1990 prices)

Category	*1985*	*1986*	*1987*	*1988*	*1989*
Premium income	362	370	430	367	446
Recoveries	212	340	337	179	234
Claims paid	1 026	1 367	2 027	1 525	2 215
Profit/loss	-409	-674	-1 291	-1 153	-171
Exports insured	17 967	18 322	21 307	18 984	24 449
Share of total exports (%)	5.8	4.8	4.6	4.6	4.3

Source: Derived from Carnevale The Euromoney 1991, p.33

Hermes may refuse to provide cover if it considers the risk too high. There is also an upper limit on transactions, so that large projects are often excluded. While Hermes has insured only a small

share of exports, it has made losses over the past few years (Table XIV.4). According to Austrade (1990), further losses are expected which will require ongoing Government funding, even though Hermes has raised premiums.

Tax incentives

Nominal tax rates in Germany are relatively high: the standard corporate tax rate is 50 per cent and the highest personal tax rate 53 per cent. Export market promotion expenditure is tax deductible.

Germany also offers indefinite carry forward of trading losses and is one of 8 OECD countries which permit carry back of trading losses (2 years in the case of Germany). Using this, a German company which buys into a foreign partnership or opens a branch may take foreign losses into its own account to the extent that these are not relieved in the foreign state in the year that they are incurred. Germany also overcompensates for economic double taxation of dividends by giving both full imputation to the shareholder and subjecting distributed profits to a lower corporate rate than retained profits. Accelerated depreciation is available for small companies only. The OECD (1991) recently estimated that, for manufacturing industry in Germany, the average pre-corporate tax required rate of return necessary when the real interest rate is 5 per cent is a little less than the OECD average. (See Chapter 6 for more detail.)

The standard VAT rate in Germany is 14 per cent, but exports are tax-free (zero-rated) including services provided in direct connection with the export of goods (transport, storage and certain agency charges).

Research and development

The high quality of German production and its use of advanced technologies requires substantial investment in R&D. As noted by Klodt (1987), German industry has successfully exported high-tech, R&D-intensive goods with low levels of Government assistance compared with the United States, the United Kingdom, and France (but not Japan).

The Government offers several R&D incentives including:

- `Initial Technological Innovation' and `Contract R&D' assistance which provides grants of 30 to 40 per cent of the costs of outside research (that is, hire of consultants or experts) to a ceiling of DM120 000 (about $A95 000) per firm per year. For spending above this ceiling, the Government provides a grant to cover 7.5 per cent of the excess cost.

- Fixed assets acquired for R&D purposes qualify for accelerated tax depreciation of:

  -- 40 per cent if immobile, and

-- 10 to 15 per cent (depending on the extent and use for R&D, compared with other business purposes) if mobile.

Companies must depreciate each asset within the first five years after acquisition (Price Waterhouse 1988, p.36).

- Tax-free investment grants which cover 20 per cent of costs up to a ceiling of DM500 000 (about $A400 000) in any tax year.

- Grants for SMEs, mainly to cover a share of personnel and development costs.

XIV.4 Effects of export enhancement measures

The Commission has not found any studies of the effects of German export enhancement measures on the German economy. However, apart from massive subsidies to the agricultural sector, Government assistance to export industries appears to be relatively low. With only a few exceptions, the Government tends to avoid `picking winners' and instead offers relatively non-distortionary assistance such as export promotion and finance. However some German Government export incentives have had considerable international effects. An example is the Airbus project, which is now achieving its first signs of success after considerable assistance from European governments (mainly French and German) in the form of production and R&D subsidies, preferential loan rates to aircraft buyers, and subsidies to offset currency fluctuations movements. Aero-Space Technologies of Australia Pty Ltd argues that the export incentives the German Government (and others) offer to the aerospace industry are disadvantaging Australian industry competing in the world market (Sub. 14).

XIV.5 Concluding Comments

International trade is very important for the German economy. In general, Government policy promotes free trade and does not offer substantial financial incentives to industry. The clear exceptions are the massive subsidies to agriculture (which is highly subsidised by the European Community) and coal mining, and the assistance provided to some specific sectors such as commercial aircraft.

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XV UNITED KINGDOM

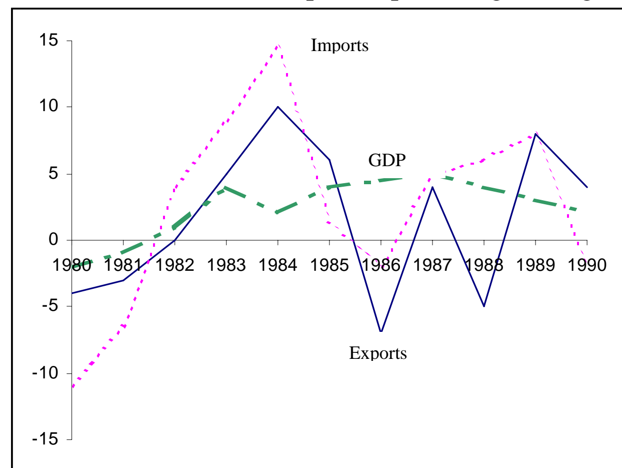
In the 1980s, the UK's Conservative Government adopted a policy of reducing state intervention in the workings of the economy. Substantial supply side reforms were introduced including deregulation and privatisation. Labour, product, and capital markets are probably some of the most deregulated among OECD countries.

There was a significant turnaround in the UK's current account in the 1980s from a small surplus in 1985 to a deficit of 3.5 per cent of GDP in 1989. The 1990 recession, however, produced a fall in the deficit to around one per cent of GDP.

XV.1 Trade performance

The UK's share of world exports was 4.9 per cent in 1989 (GATT 1990). Exports grew steadily over the 1980s: by some 2 per cent per year in real terms. Over the same period real import growth averaged about 3.5 per cent per year, while real GDP growth averaged about 2.5 per cent annually (Figure XV.1).

Figure XV.1: **The United Kingdom's growth in GDP and trade: 1980-1990**
(Constant prices, percentage change)



Source: *IMF* 1991

The UK has traditionally been an exporter of manufactured goods and an importer of food and raw materials. In 1989, manufactured goods accounted for 63 per cent of total exports. Trade in services is also significant, accounting for about a quarter of total exports (Table XV.1)

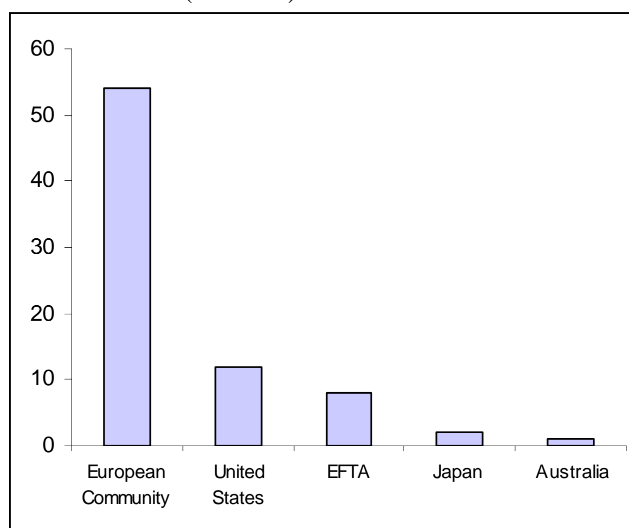
Table XV.1: **Exports from the United Kingdom: 1989**
(Per cent)

Non-manufactures	12
Chemicals	10
Other semi-manufactures	12
Machinery	22
Other finished manufactures	19
Financial services	12
Other services	12

Source: FCO 1991

The UK's trade is mainly -- and increasingly -- with other industrialised countries, accounting for 80 per cent of exports and 86 per cent of imports in 1989 (Figure XV.UKfig2). Nearly half of this trade is with other EC countries; this is expected to increase with the completion of the European Single Market in 1992.

Figure XV.1: **Major destinations of the United Kingdom's exports: 1990**
(Per cent)



Sources: OECD 1991b

XV.2 Trade and industry policy

UK trade and industry policy is increasingly dominated by obligations and issues arising from membership of the EC. UK trade policy interests are represented by the EC which acts on behalf of all EC member states on trade matters. As part of the program to develop a single European market, the EC Commission has intensified pressure on member states to reduce the incidence of general subsidisation of industry and to increase competition inside the EC.

The UK has generally aligned itself with those member states which favour wider application of liberal economic policies inside the EC. It has been one of the most consistent advocates for

reform of the Common Agricultural Policy (CAP), although the strength of advocacy has at times been tempered by concern to ensure that UK farmers receive their `due' under the CAP.

The 1979 election of the Thatcher government brought a renewed policy emphasis on the free-enterpise system. Industrial policy was viewed as part of a general economic strategy which favoured aggressive competition, flexible labour and capital markets, and reduced emphasis on sectoral policies OECD 1986). Competition is promoted through the removal of unnecessary administrative complications, reductions in taxation and low inflation policies. Specific assistance schemes do exist, however, and are aimed at promoting small and medium-sized enterprises, reducing regional disparities, increasing R&D and improving labour market flexibility (OECD 1990b).

Western Europe, Japan, the Asia/Pacific Rim and North America remain priority markets for export. A close eye is being kept on Eastern European countries, which are expected to open up significant trade opportunities in the longer term.

The British Overseas Trade Board (BOTB) has 17 Area Advisory Groups providing advice and information on the world's main trading areas. Each group prepares Action Plans that set out a list of target sectors. The end result is a complex strategy that identifies specific export priorities for over 40 countries. The UK sees the expansion of finished manufactured exports as the focus of its future trade policy.

Several sectors are considered priority areas for future export activity: tourism; computer software and hardware; financial services; pharmaceuticals; scientific instruments; medical equipment; electronic components; defence equipment; power generation and supply; telecommunications; airport equipment; processed food; pollution control; and gas and oil equipment (BOTB 1990).

XV.3 Export enhancement measures

In common with many other industrialised countries, the provision of export finance and marketing assistance is the most significant method by which the UK provides assistance to exporters. In 1988-89, Britain's official export finance agency showed a trading deficit of œ441 million ($A1100m)[1], and in 1990-91 expenditure on marketing assistance was œ135 million ($A336m).

[1] $A estimates used in this report are express in terms of 1990 Australian prices.

Export marketing assistance

The British Overseas Trade Board (BOTB), which is the export arm of the Department of Trade and Industry (DTI), guides Britain's export promotion program. DTI and the Foreign and Commonwealth Office (FCO) have recently co-ordinated and streamlined their export promotion work under the aegis of a new joint directorate: *Overseas Trade Services.*

DTI's role is essentially one of facilitation. Table XV.2 provides details of the types of services offered and their cost. Some schemes involve partial financial support, while others are provided on a full cost recovery basis. Readily available information and general economic advice is provided free.

Table XV.2: **The United Kingdom's export promotion spending: 1990-91a** ($A million)

Services	*Expenditure net of Receipts*
Overseas Trade Fairs	39.1
Overseas Projects Funds	11.2
Export Marketing Research Scheme	8.7
Non-official trade organisations	7.7
Missions and seminars	5.7
Marketing and publicity	5.0
Publications	4.0
Overseas Store Promotions	2.7
Other schemes	9.5
Market Entry Guarantee Scheme [b]	-1.7
Net total direct expenditure	**91.9**
Staff costs and overheads	
DTI Overseas Trade Divisions	43.3
DTI Regional Offices	12.2
FCO commercial staff overseas	187.8
Grand Total	**335.2**

a Forecast.
b Closed to new applicants -- figures for receipts.
Source: BOTB 1990

Part of the cost of services is offset by receipts from business, the majority consisting of contributions paid by firms participating in trade fairs and overseas missions. A growing source of income is from publications, market information inquiries and the use of DTI's overseas representation service. Income from all these sources is expected to total œ16.5 million ($A41m) in 1990-91. This represents a cost recovery of about 30 per cent on direct expenditure.

Export finance assistance

The Export Credit Guarantee Department (ECGD) assists exporters of both goods and services in two principal ways. It insures them against the risk of not being paid and it provides guarantees of 100 per cent to bank loans for goods and services sold on credit. It thereby helps exporters pursue an aggressive marketing policy without fear of potentially crippling losses.

The Government has recently reorganised ECGD to separate its two main operations -- the Insurance Services Group (ISG) which covers exports on short-term credit and the Project Group which handles capital and project exports on medium-term credit (ECGD 1989b).

ISG was converted into a wholly owned Government company on 1 April 1991 and is being privatised (Box XV._). The Project Group, which was retained by the Government, has undergone a major revamp designed to impose discipline on ECGD's finances. Premiums are to be tailored more closely to risk so that there is no cross-subsidy between good and bad risks. This means premium increases for insurance and guarantees in riskier markets.

Box XV.1: **Privatisation of the United Kingdom's export insurance**

A number of reasons have been advanced for the privatisation of ECGD's short-term division, the Insurance Services Group:

- There is the Treasury view that the œ1 billion ($A2.5b) cost of ECGD support was exorbitant. ECGD's net claim payments amounted to some œ600 million ($A1494m) and interest rate subsidies cost about œ400 million ($A996m). Treasury believed this was an excessive price for supporting some œ2 billion ($A5b) of capital goods exports (*Financial Times* 1991).

- most of the short-term business covered commercial risk in rich markets. This is a relatively safe, low-margin activity, where volume is vital, especially in light of the expected consolidation of the European credit insurance industry under the 1992 EC Single Market program. Allowing an unprivatised ECGD to expand into other European countries would lead to a British Government agency insuring the exports of foreign firms. The privatisation of the Insurance Services Group would enable it to expand unfettered into the growing European market.

- there was a belief that, if ECGD continued in its present form, legal action would be taken in the future by the EC Commission on the grounds that such assistance amounted to state aid.

Export insurance

The Insurance Services Group provides Comprehensive Short Term (CST) policies -- one of ECGD's activities to be privatised. CST policies are designed for all types of export businesses that sell on credit of up to 180 days. Guarantees are normally issued for one year and may be renewed annually. CST policies offer post-shipment cover for both commercial and political risks.

ECGD also provides a number of other programs including pre-shipment cover, bond risk cover, investment insurance, and commercial forward foreign exchange facilities.

Export credit

ECGD offers standard supplier and buyer credit services to exporters.

For exports involving credit terms of two years or more, exporters and overseas importers have access to bank finance at fixed rates of interest through the Fixed-Rate Export Finance Scheme. The banks receive guarantees from ECGD that their lending will be repaid. This facility offers both pre-shipment and post-shipment financing and is available in a wide range of currencies. If interest rate movements are such that a commercial rate of return is not obtained, interest support is provided to compensate the banks for any shortfall.

In 1990-91, the total net cost to public funds of interest support for fixed-rate export finance was over £400 million ($A996m); the cumulative bill for the preceding decade was about £3.5 billion ($A8.7b).

ECGD's financial performance

The ECGD was under instruction to run its insurance business at no net cost to public funds and cash surpluses were recorded by ECGD in most years up to the early-1980s. Subsequent rescheduling of medium-term to long-term commitments led to continuing high claims levels and large deficits and the flow of new premium income was not sufficient to cover losses in the early-1980s. Exporters were making heavy claims on ECGD and premium income was falling because of a declining market for its products.

Between 1982 and 1989, there was a decline in export business supported -- £19 billion ($A47b) to £15 billion ($A37b) -- and in the proportion of exports covered (34 per cent down to 20 per cent) (Kemp 1989). A cumulative notional cash surplus of £481 million ($A1835m) in 1982, declined by 1987 to a cumulative notional deficit of £523 million ($A1577m). A year later the deficit had more than doubled to œ1164 million ($A3287m) (Kemp 1989, p.11)

The less than impressive financial performance of ECGD over the 1980s has continued. In 1988-89 the Project Group lost heavily, as did part of the ISG: ECGD's trading result for the year showed a deficit of £441 million ($A1098m) (Table XV.3).

ECGD's 1990 accounts indicate enormous losses on longer-term credits, showing a deficit of over £3 billion ($A7.5b). The loss was entirely due to an almost £4 billion ($A10b) increase in the provision for bad and doubtful debts which now stand at over £7 billion ($A17.4b). Borrowings from the Government's Consolidated Fund are expected to continue rising, reaching a peak of close to £6 billion ($A15b) in 1996 (Montagnon 1991a).

These views were supported by an evaluation of the economic effects of the Aid and Trade Provision by Morrissey (1991, p.123):

> ... ATP is bereft of economic justification; the benefits it confers on some firms are more than offset by the costs imposed on other firms and on taxpayers. ... Mixed credits are likely to be a subsidy from donor taxpayers to a small group of major exporters.

Table XV3: **The United Kingdom's ECGD: premium income and trading result for 1988-89**
(1990$A million)

	Premium income	*Trading result*
Insurance Services:		
Short term credit insurance	170.0	31.4
Extended term credit insurance	30.4	-150.7
Project Group:		
Credit insurance facilities	234.6	-972.1
Bank guarantees	3.0	-35.1
Soft loan guarantees	35.1	34.4
Overseas investment insurance	2.7	1.0
Other facilities	0.5	-6.7
Net Total	**476.3**	**-1097.8**

Source: ECGD 1989a

Mixed Credits

The Aid and Trade Provision (ATP), which was established in 1977, is a separate allocation within the UK's bilateral aid program. ATP funds are traditionally deployed in the form of a grant in conjunction with an export credit. In 1991-92, some £97 million ($A242m), or about 6 per cent of the total overseas aid budget, has been allocated to the ATP for mixed credits. This represents a significant reduction in spending on mixed credits by the UK (see Volume 1, Table 5.6).

In 1985, a `soft loan facility' was introduced under the ATP. Under this facility, long term loans at concessional rates of interest are extended to finance projects mutually agreed between the donor and recipient governments. Commercial banks fund the loans, repayment is guaranteed by ECGD, and interest support is made available through the ATP. Borrowers are required to meet the same industrial, commercial and developmental criteria applying to mixed credits (OECD 1990a).

Tax incentives and concessions

The UK has a two-tier personal income tax system with a basic rate of 25 per cent applying to the first £20 700 ($A51 543) and a rate of 40 per cent applying to income above this level. The main corporate tax rate is 35 per cent, with a reduced rate of 25 per cent for small companies (ie those with annual profits below £200 000 ($A498 000).

General depreciation rates for plant and equipment are 25 per cent per annum on a `reducing balance' basis, although special arrangements exist for items treated as a short-life asset. There is a 100 per cent allowance for expenditure on scientific research.

Exports of goods and services from the UK are zero-rated for value added tax (VAT) purposes. This enables exporters to claim repayment of previous VAT payments. (Price Waterhouse - UK p. 43)

Research and development

In 1988, £1.1 billion ($A3.1b) in R&D funding came from Government sources, representing about 17 per cent of total public and private R&D expenditure. R&D support is focused on export-oriented industries, the main ones being electronics, chemicals, aerospace, motor vehicles and mechanical engineering. Significant R&D funding is also directed to the defence equipment sector, which is a major UK exporter.

XV.4 Effects of export enhancement measures

Debate has taken place in the UK as to whether the Government should be subsidising exports through fixed-rate export credit and mixed credit programs. Byatt (1984) argued against the use of these programs because a large part of the subsidy goes to the foreign importer. This reduced the real incomes of UK residents, as did the continuing burden of paying interest subsidies long after the exports concerned have been delivered.

Export credit guarantees

An agreement of opinion in the UK about the importance of exports meant that, from the 1950s to the 1970s, there was no `anti export credit' lobby in Britain as there was in some other countries. According to Kemp (1989, p.28), this environment may have encouraged the overuse of export credit:

> With hindsight, it may now appear that this general British enthusiasm for exports, coupled with a booming world market for development projects during the 1960s and 1970s, led to undesirable excesses. The build-up in the level of credit liabilities to a degree that proved unsustainable ... was arguably not in the best long-term interests of either the exporting or the buying countries.

Apart from world economic recession and the debt crisis in the 1980s, research commissioned by ECGD suggested reasons for the downward trend in business:

> ... the trade sectors in which the ECGD has won the highest share of business in the past have been those that have been amongst the least successful in the 1980s. Contrariwise, the industries where exports have been expanding most quickly in recent years have tended to be those making least use of credit insurance and ECGD in particular (reported in Kemp 1989 p.36).

These conclusions do not inspire confidence in the export-enhancing efforts of export finance assistance generally or the activities of the ECGD in particular. The excessive cost of export credit subsidies has led the UK to argue strongly for tighter international disciplines in their use (see Volume 1, Chapter 5).

Mixed credits

The UK Government has received complaints from capital goods exporters because the £97 million ($A242m) allocated to mixed credits under the ATP in 1991-92 was fully committed less than one month into the financial year. Some exporters also expressed alarm at what they saw as Government efforts to undermine the ECGD through its part-privatisation program.

The lack of official sympathy reflects the fact that some sections of the Government have always viewed the ATP with scepticism. The Treasury is concerned that the ATP constitutes another subsidy to exporters on top of those already received through the ECGD. ATP credits account for some 15 per cent of ECGD's book, and it has been argued that the facility leads to the concentration of ECGD's business in a limited number of markets (Montagnon 1991b).

Part of the problem relates to the funding of concessional loans. The Government built up a large volume of lasting commitments in the first three years of its concessional loan program. The result is that part of the ATP budget is automatically taken up with subsidies on loans agreed some years ago. To alleviate this problem, from 1991-92 the Government will pay lending banks a sum equivalent to its total grant commitment during the drawdown period of the loan rather than making a series of pay-as-you-go subsidies each year until the loan matures.

Impact on Australia

Leaving aside agriculture (see Volume 1, Chapter 4.2), some of the UK's export enhancement measures considered here have had detrimental effects on the ability of Australian firms to compete in third markets. According to the Wilson Transformer Company Pty Ltd (Sub. 26, p.3), the use of concessional finance by the UK, in particular mixed credits, has had a detrimental effect on its ability to bid successfully for projects in South-East Asia. Wilson cited the loss of a hydro-electric project in Malaysia because `Britain's Overseas Development Agency ... provided a soft loan ... The interest rate is reported to be 0.809 per cent payable over 14 years with a 6 year grace period.'

In a submission from the Australian Book Publishers Association Ltd (Sub. 17, p.5), the Commission was told that Australian publishers were placed at a competitive disadvantage due to the assistance provided by other countries, in particular the UK:

> ... considerable government assistance is forthcoming to the publishing industries of two of our major competitors, viz., Canada and the UK. Generous Board of Overseas Trade subsidies to British publishers considerably facilitate their participation in a broader range of book fairs than that considered possible by their Australian counterparts.

XV.5 Concluding comments

In the UK, spending on export enhancement measures, while not as large as in some other EC countries, has come under scrutiny in recent years. Direct expenditure on exports may be limited mainly to promotion and finance, but these measures are part of a larger package of industry incentives that are persue by regional and other objectives. Since these more general industry incentives also cover exporters, it is difficult to guage separately the impact or success of the export incentives.

In the area of export finance, there have been questions as to whether some activities could be carried out by private industry. The dramatic increase in export finance subsidies during the 1980s has, in the UK and other developed countries, raised concerns about the growing debt of official export finance agencies. The lack of clear evidence that such large subsidies have resulted in a net gain to the economy has contributed to the scrutiny of ECGD's activities. The part-privatisation of the Department is a response to these concerns.

Over the 1980s, Government policy has moved away from being interventionist, to focus on creating a better overall economic environment in which private enterprise can prosper. The tight UK fiscal environment has increased discipline in all areas of public expenditure. The absence of evidence that export enhancement spending has constituted `value for money' has placed continued heavy government subsidies under pressure -- for example, appropriations for mixed credits have been cut substantially in recent years.

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