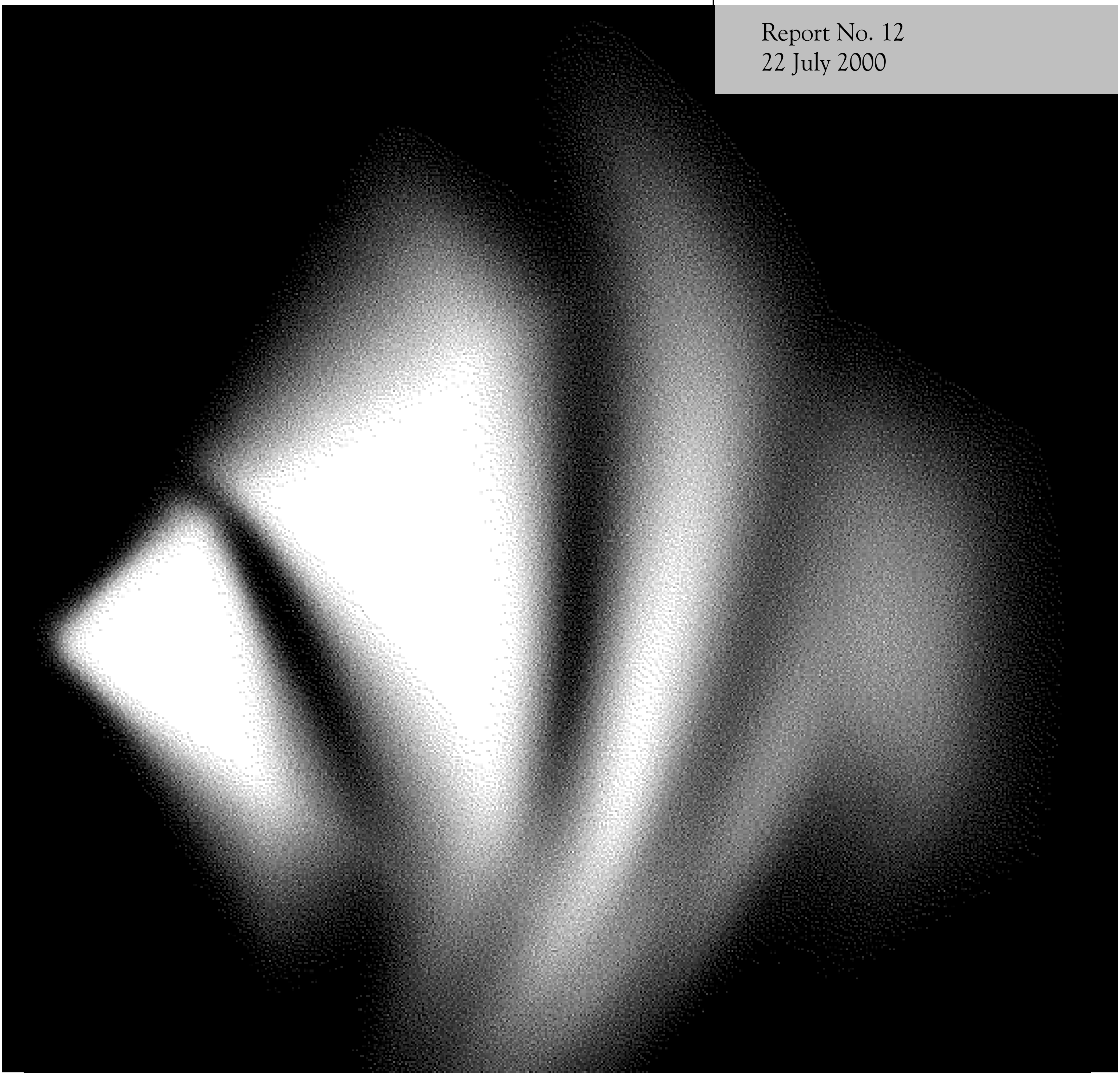
PRODUCTIVITY
COMMISSION

Review of Australia's General Tariff Arrangements

Inquiry Report



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Inquiries:
Media and Publications
Productivity Commission
Locked Bag 2
Collins Street East Post Office
Melbourne Vic 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

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The Productivity Commission

The Productivity Commission, an independent Commonwealth agency, is the Government's principal review and advisory body on microeconomic policy and regulation. It conducts public inquiries and research into a broad range of economic and social issues affecting the welfare of Australians.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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Canberra Office

Level 3, Nature Conservation House
Cnr Emu Bank and Benjamin Way
Belconnen ACT 2617

PO Box 80
Belconnen ACT 2616

Telephone 02 6240 3200
Facsimile 02 6240 3399

Melbourne Office

Telephone 03 9653 2100

PRODUCTIVITY COMMISSION

22 July 2000

Senator the Hon. Rod Kemp
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's report on the *Review of Australia's General Tariff Arrangements*.

Yours sincerely

John Cosgrove Presiding Commissioner	Mike Woods Commissioner

Terms of reference

I, ROD KEMP, Assistant Treasurer, pursuant to Parts 2 and 3 of the Productivity Commission Act 1998, hereby:

1. refer the scope for a post-2000 reduction in the general tariff (covering only rates of 5 per cent or less, and excluding the PMV and TCF sectors) for inquiry and report within 9 months of receipt of this reference;
2. request that the Commission consider the Government's desire to:
   (a) improve the overall efficiency of the Australian economy;
   (b) encourage the development of sustainable, prosperous and internationally competitive industries in Australia;
   (c) promote the provision of high quality, competitively priced goods and services to Australian businesses and consumers;
   (d) abide by Australia's international commitments, including the commitment under APEC to review its post-2000 general tariff arrangements by 2000; and
   (e) participate in a new round of multilateral trade negotiations in which bound tariff reductions will be considered by Australia and other WTO members;
3. request that the Commission report on the costs and benefits to Australian consumers, industries and their employees, and the general community, of a reduction of all general tariff rates under reference;
4. specify that the Commission's report includes options, including a preferred option, and implementation strategies for any recommended changes to general tariff arrangements that take into account:
   (a) the impact of microeconomic reform and pace of structural adjustment on Australian industry;
   (b) recent and prospective progress in regional and international trade liberalisation of interest to Australia;
   (c) other international economic and trade developments;
   (d) the impact of the floating exchange rate on the competitiveness of Australian industry;
   (e) implications for trade negotiation strategies, including how the timing of any reductions in general tariffs would best assist Australia's negotiating position at the forthcoming WTO round;
   (f) interaction with the various tariff concession arrangements including the *Manufacture in Bond* and the *TRADEX* schemes;

(g) budgetary implications, including the effects of any changes in domestic economic activity flowing from tariff reductions;

(h) the economic, social, environmental and regional policy objectives, including employment objectives, of Australian governments;

(i) existing preferential trade arrangements;

(j) the Government's commitment to the APEC goal of free and open trade and investment in the Asia Pacific by 2010 for industrialised economies and 2020 for developing economies; and

(k) the schedule for tariff reform in the PMV and TCF industries;

5. specify that the Commission, as part of its review:

   (a) report on all matters identified in 4(a) to (g) above;

   (b) identify and report on the costs and benefits of removing tariffs on tariff lines at the 8-digit level for which there is no significant Australian production; and

   (c) consider the appropriateness of the Tariff Concession System and Project By-Law arrangements; and

6. specify that the Commission take account of any recent substantive studies relevant to the above issues.

ROD KEMP

21 October 1999

[reference received 22 October 1999]

ACKNOWLEDGMENTS

The Commission wishes to thank the people and organisations which provided valuable information and views on issues covered during the course of the inquiry.

Commissioners also express their appreciation of the professional assistance which they received from the staff who worked on the inquiry.

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Abbreviations and explanations

Abbreviations

AAT	Administrative Appeals Tribunal
ABL	Australian Business
ABS	Australian Bureau of Statistics
ACCI	Australian Chamber of Commerce and Industry
AEEMA	Australian Electrical and Electronic Manufacturers' Association Limited
AIG	Australian Industry Group
ANZSIC	Australian and New Zealand Standard Industrial Classification
APEC	Asia-Pacific Economic Co-operation (forum)
APPEA	Australian Petroleum Production and Exploration Association Limited
ASEAN	Association of South East Asian Nations
CANATA	The Canada-Australia Trade Agreement
CER	The Australia New Zealand Closer Economic Relations Trade Agreement
cif	cost, insurance and freight
CTCS	Commercial Tariff Concession Scheme
Customs	Australian Customs Service
DFAT	Department of Foreign Affairs and Trade
DISR	Department of Industry, Science and Resources
era	effective rate of assistance
FIC	Forum Island Country
fob	free on board

GATT	General Agreement on Tariffs and Trade
gbe	government business enterprise
GDP	gross domestic product
GST	goods and services tax
IAC	Industries Assistance Commission
IC	Industry Commission
ISO	Industrial Supplies Office
LILI	labour input loss index
ldf	landed duty free
MiB	Manufacture in Bond
NAFTA	North American Free Trade Agreement
nra	nominal rate of assistance
PATCRA II	Agreement on Trade and Commercial Relations between the Government of Australia and the Government of Papua New Guinea
PBL	Policy By-Law
PC	Productivity Commission
PMV	passenger motor vehicles
PPMFA	Pulp and Paper Manufacturers Federation of Australia
SPARTECA	The South Pacific Regional Trade and Economic Cooperation Agreement
TCF	textiles, clothing and footwear
TCO	Tariff Concession Order
TCS	Tariff Concession System
WTO	World Trade Organization

Explanations

General tariff	The tariff which applies to imports if a lower preferential tariff or concessional rate does not apply
Preferential tariff	All imports from certain countries, and some imports from

	other countries, are subject to preferential tariffs which are lower than the general tariffs which would otherwise apply
Concessional tariff rate	Special schemes and arrangements sometimes provide for concessional tariffs to apply at rates lower than the general tariffs which would otherwise apply
Goods under reference	Goods, excluding goods in the PMV and TCF sectors, for which the Customs Tariff specifies a general tariff of more than Free but less than or equal to 5 per cent
Page reference numbers	The page reference numbers cited in this report are taken from printed copies held by the Commission. Because many submissions were originally received as electronic files, the cited page numbers may differ from page numbers in printed copies held by others

Key messages

- At 5 per cent or less, Australia's general tariffs, which assist many areas of manufacturing, are low and relatively uniform by historical standards.
- While they involve smaller costs to the community than in the past, these tariffs continue to distort producer and consumer choice and reduce the international competitiveness of a range of Australian producers.
- The interaction of the tariffs and a complex set of concessional duty arrangements causes significant monitoring and compliance costs for business.
- Further reductions in general tariffs would remove these various disadvantages and be of some small benefit to the community as a whole.
- This course of action would strengthen the perception that world-class performance is necessary for economic success in Australia.
- It would also have the effect of removing 'nuisance tariffs' — ie those applied to goods not produced in Australia.
- The consequent adjustment costs to presently assisted industries, employees and regions, whilst potentially significant for some individuals and firms, would similarly be slight overall — the competitive position of others would be improved as the prices of their inputs declined.
- These costs would be much less than those stemming from other sources of change (eg technological advances and exchange rate changes).
- Early unilateral tariff reductions would not reduce Australia's negotiating strength in the forthcoming multilateral trade negotiations.
- On balance, the Commission sees advantages in the removal of the general tariffs under review and associated concessional arrangements and recommends that:
  - the duty under concessional tariff arrangements be reduced to Free as soon as possible; and
  - the general tariff rates under reference be reduced to Free sooner rather than later, preferably on 1 July 2001 and no later than 1 January 2003.

Overview

Tariffs on imports are taxes on Australian consumers and industries which use foreign goods. While tariffs assist some local producers, the cost of this assistance is borne by domestic consumers and users — especially exporters.

Until relatively recently, Australia's tariffs have been high and disparate, resulting in considerable misallocation of resources. The Australian community has gained substantial net benefits from reductions of those tariffs, particularly since the late 1980s.

This report considers the scope for a further reduction, post-2000, of general tariffs of 5 per cent or less which assist a wide range of manufacturing activities that account for about 10 per cent of gross domestic product. Tariffs protecting the passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF) sectors are excluded.

The potential net benefits of such a reduction would clearly be smaller than those gained from past reduction programs. This is because the tariffs under review are low and relatively uniform, unlike those levied on PMV and TCF. Consequently, while distortions in production and consumption remain, they are less marked than previously and tariff-induced costs borne by users and consumers are much smaller.

The terms of reference acknowledge Australia's commitment to the APEC goal of 'free and open trade and investment in the Asia Pacific by 2010 for industrialised economies and 2020 for developing economies'. Indeed, this inquiry fulfils Australia's APEC commitment to review its general tariffs in 2000 or earlier. Although there has been no definitive statement by APEC governments on the meaning of the term 'free and open', further reduction or removal of Australia's remaining general tariffs would be consistent with this commitment.

Scope of the inquiry

Almost all of the 2000 tariff subheadings covered by the terms of reference for this inquiry have general rates of 5 per cent. In practice, the level of assistance actually received by domestic producers is affected by imports which enter at preferential (ie lower) tariff rates and by tariff concession arrangements. The latter include the Tariff Concession System (TCS) and project and other policy by-laws.

Under the TCS, a concessional tariff rate of 3 per cent has applied since 1996 to business inputs where there is no domestic production to protect, with a concessional rate of Free (ie zero) applying to consumer goods. The by-laws, which allow lower or Free rates of import duty to apply in some other circumstances, have a number of policy objectives, including assisting major resource processing and agriculture-based industries. Arrangements also exist to rebate the duty paid on, or exempt from duty, imported goods subsequently exported or included in exports.

The effect of tariff assistance received by most industries on their outputs is reduced further by the price effects of tariffs on their inputs. The net result is that the tariffs under reference provide the manufacturing sector (excluding TCF and PMV) with an average effective rate of assistance of 3 per cent.

Revenue raised from tariffs on goods under reference totalled about $1.1 billion in 1998-99, with the existing concessional tariffs accounting for about 17 per cent of this total.

The central questions in this inquiry are what rate or rates of general tariff should apply for goods under reference on and from 1 January 2001 and what changes, if any, should be made to concessional arrangements if general tariffs remain greater than Free. These questions are considered in terms of the possible benefits and costs to Australian consumers, industries and their employees, and the general community.

Participants' views

A total of 164 submissions were received from participants representing a variety of interests and views (see box 1).

Many submissions were from manufacturers which see themselves benefiting from existing tariff protection. These strongly favoured a continuation of the general tariff of 5 per cent for some or all of the tariff subheadings under reference — many on the ground that further tariff reductions by Australia should only be made on a reciprocal basis with other countries.

On the other hand, some participants proposed reductions in the general tariff before 2010, irrespective of concessions from other countries, arguing that unilateral tariff reduction by Australia would bring net benefits to the community overall. They also saw the remaining structure of tariffs and concessional duties as a nuisance, reducing their international competitiveness. Identified benefits of removal of the tariffs include lower costs for user industries and consumers, encouragement for Australia's export sector and reduced costs of government administration and business monitoring and compliance.

Box 1 **Views about tariffs**

General tariffs

Australian Industry Group: 'a further reduction in Australia's general tariff … would involve considerable risk with little potential benefit'.

Kenworth Trucks: 'PMVs are being treated as a special case. HCVs [heavy commercial vehicles] are part of the Australian Automotive Industry. They too should be afforded special treatment … The current tariff of 5% should remain pending a full and complete review of all Automotive Industry participants'.

Tasman Sinkware: 'removal of tariff … will have a serious impact on our business'.

Australian Chamber of Commerce and Industry: 'General tariff rates be reduced in the context of multilateral negotiations, or 1 January 2005 at the latest'.

Printing Industries Association: 'a zero tariff regime should be introduced on 1 January 2005'.

Australian Music Association Inc.: 'A tariff of 5% on this category [electric guitars] particularly only serves to increase the price of instruments to the consumer, and offers very little real protection or benefit to Australian manufacturers and makers, who tend to produce higher cost (sometimes individualised) instruments'.

WMC Resources: 'removal of the tariff … will result in more competitively priced stainless steel products … [and] … ultimately be of benefit for nickel producing countries such as Australia'.

3 per cent tariff on business inputs

Atom Industries: 'we have to pay import duty on these engines [for lawn edgers] … whereas overseas manufacturers can bring into Australia … the entire unit duty free'.

DeWalt Industrial Power Tool Company: 'the imposition of the 3% revenue tax in 1996 on business inputs not available from local manufacture, has added significantly to input costs with an adverse impact on the international competitiveness of our local industries'.

Monsanto Australia Limited: 'focus only upon those areas of the tariff for which there are clear and demonstrable benefits to be achieved. … the 3% concessional duty … should be rescinded as soon as possible'.

A virtually universal view of participants was that the 3 per cent concessional duty for business inputs under the TCS should be reduced to Free as soon as possible, irrespective of any decision on the general tariffs under review. It was widely perceived to be merely a tax on Australian industry, given that the TCS applies only where (in effect) there is no equivalent Australian production to protect. In some circumstances, it results in manufacturers paying taxes on a major input while competing with finished goods which enter duty free. Some anomalies in its administration were also identified.

The Commission's approach

In the conduct of this inquiry, the Commission's overriding concern is to improve the wellbeing of the community as a whole in accordance with the broad policy guidelines set out in the *Productivity Commission Act 1998*. In pursuing this goal, the Commission has regard to the social, regional and environmental interests of the community.

Within this framework, in developing and considering options, the Commission has taken into account a number of criteria, including the following:

- resource allocation effects of tariffs in terms of their production and consumption distortions;
- administrative and compliance costs associated with concession arrangements;
- implications for Australia's trade negotiation strategies;
- interaction with microeconomic reform and continuing structural adjustment;
- the schedule for PMV/TCF tariff reform; and
- budgetary consequences of tariff change.

Of particular importance to the consideration of options are the likely adjustment consequences overall, as well as for particular industries and their employees, and regions.

Possible benefits of tariff reductions

General tariffs on the goods under reference increase producer and consumer prices. Although the average price distortion is not large, being of the order of 3 per cent or less, its removal could be expected to provide some benefit. Industries which use business inputs currently subject to tariffs would benefit from lower costs. These include export industries, a number of which are located in rural and regional Australia. Australian consumers should ultimately benefit from these lower costs and from the direct price reductions and improved choice flowing from reductions of general tariffs on consumer goods.

These benefits are expected to be small relative to those which stemmed from past across-the-board tariff reductions. This assessment is supported by estimates from the quantitative analysis undertaken by the Commission. Notwithstanding the caveats which must necessarily attach to such analysis, the removal of the tariffs under reference is estimated to result in a small permanent increase in overall community welfare, after accounting for adjustment costs. There would be some relocation of activity between industries and regions, as discussed below.

The actual community gains could be greater than this assessment suggests. The effects of fine specialisation and intra-industry trade are difficult to capture fully with available techniques of quantitative analysis. Moreover, the removal of the general tariffs on the goods under reference would strengthen the perception that world-class performance is necessary for economic success in Australia. It would also be a step towards more general policy rules which avoid as far a possible specific discrimination among activities, businesses and people. Such an approach is likely to be more conducive to community welfare.

Elimination of general tariffs for goods under reference would render tariff concession arrangements redundant. As a result, an area of complex regulation could be dismantled, removing what is seen by many domestic producers as an unwarranted nuisance. It also would result in cost savings for government administration and free industry of monitoring and compliance burdens. These costs are estimated to be in excess of $7 million per annum.

In the past, the majority of the efficiency and welfare gains for Australia from trade liberalisation have derived from removal of its own trade barriers. Thus, postponing liberalisation by Australia, in the hope that this would have increased negotiating strength and would have allowed Australia to derive additional ‘concessions’ from other countries, would have incurred a high cost.

Now, however, overall gains from further reductions in the general tariffs under reference are likely to be small. Nevertheless, unilateral tariff removal would not reduce Australia’s negotiating strength — the Department of Foreign Affairs and Trade suggests that it might even increase it. This is because tariff negotiations in international forums, such as the WTO, usually involve discussions about offers to place restrictions on the maximum duties for individual categories or classes of goods — ie bound rates rather than the often lower rates actually applied. In Australia’s case, as opposed to most other OECD countries, many of these bound rates are currently considerably higher than the duties actually applied. Australia’s negotiating strength is constrained, however, by its small share of world trade (less than 1 per cent).

Possible costs of tariff reductions

As well as these benefits, reduced tariff assistance could also involve adjustment costs which, whilst potentially significant for some individuals and firms, would be slight overall and much less than those stemming from other sources of change (eg technological advances and exchange rate changes).

No further tariff reform for the PMV and TCF sectors is scheduled until 2005. As a result, industries which use a relatively high proportion of the products of those sectors as inputs into their own activities, and whose own tariffs were reduced, would be more adversely affected until then. Moreover, reduction of the tariffs under reference would also marginally increase the levels of assistance already accorded to the highly assisted PMV and TCF sectors. These additional short-run effects are likely to be only minor, however, relative to the ongoing distortions arising from PMV and TCF assistance.

The removal of tariffs on goods under reference would result in some reduction of government revenue. The potential reduction would be minor compared with Commonwealth revenue in total — well under 1 per cent. It would be small even compared with the recent average annual growth in Commonwealth tax revenue.

Some participants expressed concern that a further lowering of tariffs would lead to a widening of Australia's current account deficit and reduce Australia's capacity to service its overseas debt. However, the operation of a flexible exchange rate, improved macro-economic policies and the reduction in exporters' input costs brought about by tariff reductions suggest that such concern is misplaced. In fact, the historical record since the systematic across-the-board tariff reductions began in the late 1980s shows that the current account deficit has changed little, while debt service capacity has increased.

Adjustment

To the extent that future tariff reductions could have adjustment consequences for particular industries and regions — whether beneficial or adverse — these need to be seen in the context of continual structural change experienced by industries and regions (see box 2). Changes in general economic conditions (such as changes in overseas markets, new technology, population growth and variations in exchange rates) are an important part of that context. So too, are changes in government policies to foster long-term economic growth, protect the environment, provide public infrastructure and assist the disadvantaged in the community.

Box 2 **Indicators of ongoing structural change**

Increased trade in goods and services

Progressive trade liberalisation, together with a decline in the real exchange rate has played a significant role in the growing importance of trade over the last few decades. Trade intensity (exports plus imports of goods and services as a proportion of GDP) has increased from 34 per cent of GDP in 1987-88 to 40 per cent in 1998-99. Growth in exports as well as imports of manufactured goods has accounted for a substantial part of this increase.

Sectoral change in output and employment shares

Over the last decade there has been considerable growth in output and employment:

- Australia's total output increased by about 45 per cent between 1987-88 and 1998-99 (in 1997-98 prices);
- the service sector's share of production increased from 73 per cent in 1987-88 to 76 per cent in 1998-99, while the manufacturing sector's share fell from 19 per cent to 15 per cent;
- the number of people employed economy-wide increased from 7 million in 1987 to 8.7 million in 1999;
- manufacturing sector employment declined until the end of the recession in the early 1990s — since then, manufacturing employment has largely stabilised and manufacturing output has increased by 15 per cent; and
- the service sector now accounts for almost 80 per cent of total full-time employment in Australia.

Population movement

The mobility of the workforce has a bearing on the capacity of the community to adjust to changes in the structure of production and employment. Although some people find it difficult to move, ABS data indicate that many are relatively mobile.

- Of the people who worked during the year ending February 1998, 14 per cent or 1.3 million changed their employer and/or their location of work. Of these, 40 per cent changed their industry and 34 per cent changed occupation.
- Between 1991 and 1996, nearly 800 000 people in total relocated to another State — New South Wales had the largest number of departures (243 000) and Queensland the largest number of arrivals (268 000).

In such a dynamic environment, the overall adjustment consequences of removing the tariffs under reference, like the benefits, would be small. Also, given the high level of awareness of Australia's APEC commitments, further tariff reductions are likely to have featured in the forward planning of many firms and industries, mitigating the adjustment consequences.

At the industry and regional level, the adjustments to the tariff changes themselves are estimated to involve only small costs. At the same time, by reducing input costs, tariff reductions would alleviate the need for adjustment by other industries and regions which may arise from other sources of change. The estimated labour market adjustment costs are not always adverse. They include transitional costs incurred by people moving to take up opportunities to improve their earnings, as well as costs incurred by those displaced from work.

Consequences of tariff reductions for particular industries and regions

Although many producer participants spoke in general terms about possible adverse effects for Australian industry from general tariff reductions, specific comments about adverse adjustment consequences for particular industries or regions were less extensive. Further, although some of this activity was located in rural and regional Australia, much of it was in major urban areas.

The Commission's analysis shows some possible adverse effects from tariff reductions on the industries singled out by participants. The estimated magnitude of the effects is small overall and much less than predicted by participants. The analysis shows a mixture of marginal increases and decreases in value added and employment in industries and regions, nine years after removal of the general tariffs under reference. This, of course, is not to deny that the changes could be more important for some individuals and firms and that some individuals may need to draw on the generally available social safety net arrangements and employment assistance programs.

A comparison of recent changes in regional employment with the estimated relocation of jobs among regions resulting from removal of the tariffs under reference provides a perspective on the magnitude of potential regional employment effects. This indicates that in all but one of the 57 regions examined, the estimated effect of removing the tariffs under reference is either to increase employment or to reduce it by an amount which would be equivalent to less than one year of recent employment growth or loss.

The analysis of the regional employment effects of removing the tariffs suggests that some participants might be factoring the effects of other economic changes into their predictions. All industries are subject to continuing competitive and adjustment pressures from a number of sources — tariff reductions are just one.

Concessional tariffs

The concessional tariff of 3 per cent under the Tariff Concession System and project and other policy by-laws raises a modest amount of revenue for the Government – less the $200 million a year. At the same time, it imposes a competitive disadvantage on Australian manufacturers who use those inputs, as well as raising costs borne by their customers. Reduction of the concessional rate to Free (ie zero), as requested by participants, is estimated to bring net efficiency benefits to the economy, after accounting for adjustment costs. This is because a large proportion of the concessional imports are machinery and equipment which are used in unassisted production.

The Commission has concluded that there would be merit in removing the duties applicable under concessional arrangements as soon as possible, irrespective of a decision on general tariffs. As those most directly affected are likely to benefit, there is likely to be little advantage in giving a period of notice of the change.

RECOMMENDATION 1

The concessional tariff rates for business inputs under the Tariff Concession System and for policy by-laws items 43, 47 and 52 be reduced to Free as soon as possible.

Provided that this recommendation were implemented, it would be possible to leave the concessional arrangements otherwise unchanged until, say, 1 January 2003. However, if the tariffs under reference were to remain unchanged beyond then, the policy objectives and administration of the concessional arrangements would need to be subject to re-evaluation. That is a matter which would require detailed study.

Nevertheless, in that event, there could be merit in expanding the scope of project and other policy by-laws — for example, by reducing the project threshold from $10 million to $5 million. Provided that the scope was clearly restricted to inputs to unassisted activities which typically improve welfare, any past need for detailed case-by-case analysis of the effects on Australian industry could be reduced. In expanding scope in this way, however, there would be a need to balance any extra administrative and compliance costs against the assistance benefits for the overall community.

General tariff options

Even with an early reduction to Free of the present concessional tariff duties, there would still be an additional small permanent increase in community welfare available from removal of the general tariffs under reference. This additional benefit, net of estimated adjustment costs, would be greater than that likely from the reduction in concessional tariffs.

Although further reductions of general tariffs, by themselves, are unlikely to result in sizable increases in real incomes of Australians, they remain part of an important wider policy agenda. Continued implementation of policies, including tariff reform, designed to improve the structure and performance of the economy, will improve community welfare. Furthermore, removal of tariffs on the goods under reference would also be consistent with the policy objective agreed by all Australian governments that barriers to competition should be removed unless they can be shown to be in the community's interest.

The Commission has considered the case for maintaining the status quo — that is, making no unilateral changes in the decade to 2010. For reasons set out below, however, it has concluded that to do so would involve forgoing some worthwhile gains. Accordingly, the Commission has formulated four specific options for the general tariffs under reference for consideration by the Government:

- set general tariffs at Free (ie zero) in the near future, say 1 July 2001, to obtain the gains as soon as practicable;
- set general tariffs at Free following a longer period of notice, say 1 January 2003;
- phase general tariffs down, with a reduction to 2.5 per cent on 1 July 2001 and set at Free on 1 January 2003; or
- set general tariffs at Free on 1 January 2005 to coincide with the scheduled reduction in PMV/TCF tariffs.

When assessed against the criteria outlined earlier, there is no single option which stands out as clearly superior. Each of them would have the effect of removing 'nuisance tariffs' — ie those applied to goods not produced in Australia.

The early removal of the remaining general tariffs would enable the earliest practical realisation of the overall community benefits arising from such an action. There would be benefits for some firms and people as a result of reductions in their costs. Others would incur adjustment costs, which are similarly assessed to be marginal, capable of being met by the generally available social safety net arrangements and not requiring extensive phasing-in periods. Little significant effect on labour in any industry or region is likely.

A further benefit arising from earlier removal of the general tariffs under reference would be the ability to abolish the associated tariff concession arrangements. An area of complex regulation could be dismantled, with savings to government and businesses. If the tariffs were not set at Free by at least 2003, it is the Commission's view that the Government would need to undertake a detailed consideration of the policy objectives and administrative shortcomings of the current arrangements.

Removal of the tariffs would not reduce Australia's negotiating strength in forthcoming multilateral trade negotiations and might even enhance its efforts to bring about future trade liberalisation of benefit to Australian industries, including export industries in rural and regional Australia.

The option of a later tariff reduction, in 2005, would avoid a temporary period of reduced assistance for producers reliant on inputs from the PMV and TCF sectors and allow more time to plan for the government revenue consequences. On the other hand, it would delay the benefits likely to accrue to the community, necessitate amendments to the concession arrangements, add nothing to Australia's position in international trade negotiations and provide no significant lessening of adjustment pressures. If this option were adopted, the removal of tariffs would need to be legislated well in advance, in order to provide a predictable environment for decision-making and to retain some international trade negotiation benefits.

The Commission considers that there is a sufficient weight of positive factors to suggest that the tariffs under review should be reduced to Free sooner rather than later. It has therefore focused on the first three options. The choice among these options turns largely on the weight given to adjustment and government revenue considerations, relative to the overall community gain.

Option 2, setting the tariffs at Free on 1 January 2003, would provide a longer period of notice than Option 1 for industries and their employees and enable the Government to adjust to the reduction in its revenue more easily, while deferring the benefits to the general community. Option 3 stages these effects over two steps. Given that the overall benefits are likely to outweigh the adjustment costs, the Commission has a preference, on balance, for Option 1, setting the tariffs at Free on 1 July 2001. It is also of the view that this should be done no later than 1 January 2003.

RECOMMENDATION 2

General tariff rates under reference be reduced to Free sooner rather than later, preferably on 1 July 2001 and no later than 1 January 2003.

Adoption of this recommendation would make the tariff concession system and the project and other policy by-laws redundant in respect of the goods under reference.

1 Introduction

The Commission has been requested by the Government to consider the scope for a post-2000 reduction in general tariffs in Australia. The terms of reference cover tariff subheadings with general rates of 5 per cent or less. These tariffs assist a range of manufacturing activities which in total contribute some 10 per cent to gross domestic product. The passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF) sectors are excluded.

Australia’s general tariffs on imports have been reduced significantly since the early 1970s. As a result, with the exceptions of goods within the PMV and TCF sectors, and of some cheeses, all general tariffs applied to imports are now 5 per cent or less.

All imports from certain countries, including New Zealand, the Forum Island countries and Papua New Guinea, are subject to lower preferential tariff rates. Such rates also apply to particular imports from some other countries, including Canada and certain developing countries.

1.1 Background

The inquiry was announced by the Minister for Industry, Science and Resources on 1 July 1999 (Minchin 1999a). He indicated that the inquiry would fulfil Australia’s APEC commitment to review its general tariffs in 2000 or earlier. He stated that the review could also serve to reduce business costs, enhance competitiveness and examine ‘nuisance’ tariffs.

The terms of reference, received on 22 October 1999, acknowledge Australia’s commitment to the APEC goal of ‘free and open trade and investment in the Asia Pacific by 2010 for industrialised economies and 2020 for developing economies’.

‘Nuisance’ tariffs

In July 1998, the then Department of Industry, Science and Tourism commenced a review of 2141 tariff subheadings which individually account for tariff revenue of less than $100 000 per year. Members of the business community were invited to identify which of those items they believed should remain subject to tariff duty.

On 19 September 1999, the Minister made a preliminary announcement concerning the ‘removal of almost 400 nuisance tariffs — tariffs on imported goods that are not made in Australia’ from 1 November 1999 (Minchin 1999b). This matter was finalised with Customs Tariff Proposal No. 7 (1999) which listed 268 tariff subheadings for which the general rate was reduced to Free (ie zero) from 15 December 1999 (Australian Customs Notice No. 99/83).

1.2 Scope of the inquiry

More than 2700 tariff subheadings (at the 8-digit classification level) currently have general rates of Free (see chapter 2), and are thus excluded from the scope of the inquiry. In this report, the term ‘general tariff’ is taken to exclude any excise component of import duty — these excise components apply equally to locally produced goods. Further, as noted above, the inquiry excludes tariff subheadings falling within the PMV and TCF sectors.

Except for 10 tariff subheadings which are dutiable at 4 per cent, all of the remaining approximately 2000 tariff subheadings under reference are dutiable at a general rate of 5 per cent. For this reason, the rest of this report largely discusses issues in terms of possible reductions in the general rate of duty of 5 per cent. In contrast to previous tariff inquiries by the Productivity Commission’s predecessors, this inquiry deals with tariff rates which are low and uniform rather than high and disparate.

The inquiry focuses on what rate or rates of general tariff should apply for these tariff subheadings on and from 1 January 2001 (ie post-2000), having regard to Australia’s commitment to the APEC goal of ‘free and open trade and investment’.

Some participants requested increases in tariffs for particular tariff subheadings. However, the terms of reference refer to the scope for general tariff reductions and the Commission therefore is not considering possible increases in general tariffs. Nor is it considering possible increases in preferential tariffs.

In considering options, including a preferred option, the Commission has also taken into account the implications for other assistance arrangements including the Manufacture in Bond, duty drawback and TEXCO schemes, and the appropriateness of the Tariff Concession System and Project By-Law arrangements. Indeed, another important question for the inquiry is what changes, if any, should be made to concessional arrangements, particularly if general tariff rates are not reduced to Free in the near future.

1.3 The Commission's approach

In accordance with the terms of reference and the broad policy guidelines set out in the *Productivity Commission Act 1998*, the Commission's overriding concern in considering the scope for further tariff reductions is to improve the wellbeing of the community as a whole. In pursuing this goal, the Commission has regard to the social, regional and environmental interests of the community.

The Commission is of the general view that economy-wide benefits are more likely to be maximised by maintaining a relatively uniform structure of tariff rates, rather than by setting rates piecemeal according to the competitive position of particular producers or industries in respect of particular tariff subheadings. Nevertheless, there is a need to consider whether particular industries or regions would be adversely affected by general tariff reductions, especially while relatively high tariffs continue to apply to the PMV and TCF sectors.

1.4 Consultation

To facilitate participation in the inquiry and to allow the maximum degree of public scrutiny, the Commission:

- held informal discussions with 18 organisations which have a range of interests and perspectives;
- released an issues paper to assist those wishing to make written submissions;
- invited written submissions — 95 were received prior to the release of the draft report in May 2000 and another 69 subsequent to its release;
- held initial public hearings in January 2000 in Melbourne, Canberra and Sydney, with 25 organisations participating;
- conducted a technical workshop to discuss quantitative analysis of the effects of tariff reductions in Canberra in April 2000; and
- held public hearings in June 2000 in Melbourne and Sydney to receive comments on the draft report. Sixteen organisations participated in these hearings.

Appendix A lists organisations and individuals who have participated in the inquiry.

1.5 Participants' views on tariff rates

A considerable number of submissions were from manufacturers who see themselves benefiting from existing tariff protection. These strongly favoured a continuation of the general tariff of 5 per cent for some or all of the tariff subheadings under reference. The reasons differed:

- while recognising Australia's APEC commitment, many considered that further tariff reductions by Australia should only be made on a reciprocal basis with other countries;
- while recognising that the tariff is small relative to other factors affecting competitiveness, a number of participants nevertheless argued that it was vital to their long-term viability; and
- some industry sectors asked for further time to improve their competitiveness before tariff reductions were considered, even though the existing level of general tariffs has applied since 1996.

Other producers and importers proposed reductions in the general tariff before 2010, irrespective of similar action by other countries, arguing that unilateral tariff reduction by Australia would bring net benefits to the community overall. Benefits identified include price reductions for user industries and consumers, and encouragement for Australia's export sector.

A virtually universal view was that the 3 per cent concessional rate of duty which applies to business inputs under the Tariff Concession System (TCS) should be reduced to Free as soon as possible. This duty was widely perceived to be merely a tax on Australian industry, given that the TCS applies only where (in effect) there is no equivalent Australian production to protect.

1.6 Report structure

Chapter 2 places tariffs on goods under reference in context. It examines the present structure of tariff rates and the assistance they confer, provides information about tariff revenue and outlines the distinction between 'bound' and 'applied' rates.

Chapter 3 outlines the economic effects of tariffs and presents the results of quantitative analysis by the Commission of the benefits and costs of removal of general tariffs. Chapters 4 and 5 cover a number of issues related to tariff reform arising from the terms of reference which may strengthen or weaken the scope for tariff reductions. Issues relating to microeconomic reform and structural adjustment, the schedule for PMV and TCF tariff reform and the possible removal of tariffs on items for which there is no significant Australian production are addressed in chapter 4; chapter 5 discusses a number of international economic and trade aspects, including the question of linking further tariff reductions by Australia to actions by other countries.

Implications of tariff reductions for concessional arrangements are covered in chapter 6. This chapter considers the Tariff Concession System, project and other policy by-laws, Manufacture in Bond, duty drawback and TEXCO.

Finally, chapter 7 discusses the potential effects — including the likely adjustment costs — of reductions in general tariffs post-2000. Options for further tariff reductions are included to illustrate the trade-offs in arriving at tariff policy recommendations, and findings are made about the concessional arrangements. This chapter also develops the Commission’s recommendations.

2 Tariffs in context

This chapter places the general tariffs under reference in this inquiry into context in relation to:

- the current structure of Australian applied tariffs and tariff concessions as a whole;
- the revenue raised for the Government;
- tariff rates bound by Australia as part of its international commitments; and
- the history of past tariff reductions.

In doing so, this chapter examines the levels of assistance conferred on Australian producers by tariffs on competing imports.

2.1 Current tariff structure

As at 1 July 2000, just over 5700 tariff subheadings were set out in Schedule 3 of the Customs Tariff (see table 2.1). Of these, about 2750, or 48 per cent of the total, have duty free rates and are excluded from this inquiry. About 800 tariff subheadings having general rates of greater than 5 per cent are also excluded from the inquiry — 5 of these subheadings relate to cheese and the remainder to the PMV or TCF sectors. Of the remaining subheadings — that is, those with general tariffs of 4 or 5 per cent — approximately 200 relate to the PMV or TCF sectors and are also excluded.

The inquiry thus covers approximately 1950 subheadings (35 per cent) of the Customs Tariff.

Existing PMV and TCF sector duties will continue until 1 January 2005 when further reductions for that sector are to be made (see section 4.2). However, those changes (which leave those duties above 5 per cent) will not affect the structure of the tariff as summarised in table 2.1.

Table 2.1 **Australian tariff structure**

as at 1 July 2000 and beyond[a]

General rate[b]	*Total number of tariff subheadings*	*PMV sector subheadings*	*TCF sector subheadings*
Free[c]	2 758	na	183
1%	0		0
2%	0		0
3%	0		0
4%	10		0
5%[d]	2 143	na	194
Greater than 5%[e]	799	155	639
Total	5 710	na	1 016

na Not available.

a In contrast to the other data presented in this chapter, this table incorporates the effects on tariff structure of the recent automotive leather subsidies understanding between the Government of the United States of America and the Government of Australia. This involves reductions in tariffs for some 30 tariff subheadings. Unless further policy changes are made, the tariff structure shown in the table will continue to 1 January 2001 and beyond. **b** Excludes any excise component. **c** Indicates that no duty applies. **d** Total includes 2 subheadings with rates of '5% or, if lower, …'. **e** Total includes 5 subheadings (relating to cheese) with specific rate duties.

Source: Based on information provided by Customs and DISR.

Figure 2.1 provides information on tariffs by Customs Tariff chapter — the lower unfilled section of each bar indicates the simple average applied tariff rate. The figure also includes information about bound rates — see section 2.3. (More detailed information about simple average applied and bound rates is given in appendix B.) The average simple applied tariff rate varies by chapter from zero to more than 23 per cent. The higher averages are associated with those chapters including or covering TCF and PMV commodities. For other chapters, the simple applied averages reflect the proportion of tariff subheadings dutiable at general rates of 5 per cent — the closer the average to 5 per cent the higher the proportion of subheadings with that general rate.

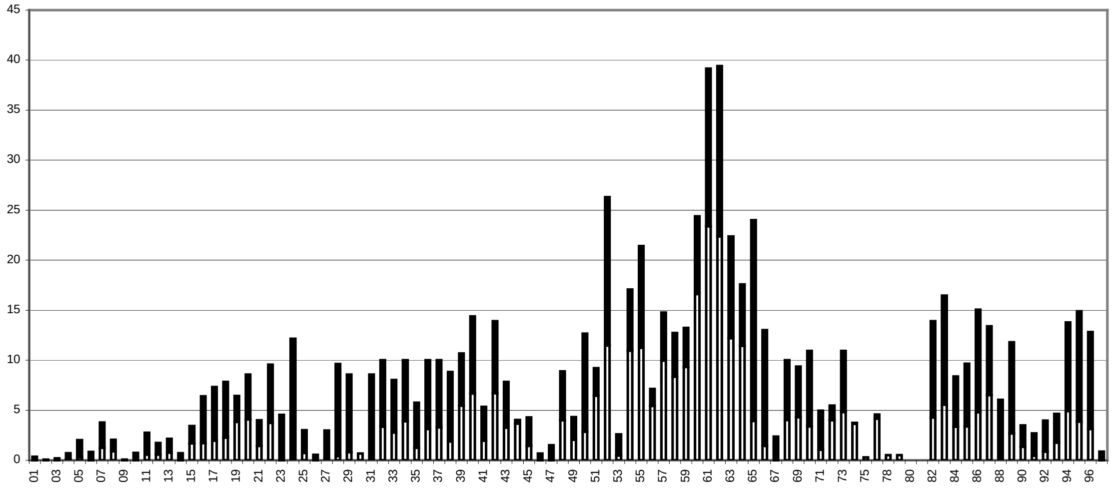
The structure of tariff rates is summarised further in table 2.2. (This table, and table 2.4, exclude the PMV and TCF sectors.) This indicates that, at least at a broad level of aggregation, all Australian manufacturing industries potentially receive some protection from general tariffs.

This inquiry focuses on general rates of duty. However, Australia accords preferential (lower) rates to imports of many commodities from particular countries or groups of countries (see section 5.2). In some circumstances, these preferences can erode levels of assistance available to Australian producers — the effects are explored later in this chapter.

Figure 2.1 Simple average applied and bound tariff rates by Customs Tariff Chapter[a]

per cent

(the height of the unfilled section of each bar represents the average applied tariff rate; total height of each bar represents the average bound tariff rate)



[a] The averages for applied and bound rates are not strictly comparable. See appendix B.

Source: Based on information provided by Customs and DFAT.

Table 2.2 Simple average general tariff rate by ANZSIC industry, 1 January 2000

per cent

ANZSIC industry	*Simple average general rate*
Agriculture, forestry, fishing and hunting	0.3
Mining	0.5
Manufacturing	
Food, beverages and tobacco	1.6
Wood and paper products	3.3
Printing, publishing and recorded media	2.1
Petroleum, coal, chemical and associated products	1.8
Non-metallic mineral products	2.9
Basic metal products	2.9
Fabricated metal products	3.8
Other vehicles	2.1
Other machinery and equipment	2.3
Other manufacturing	3.1
Other and unspecified	1.3
Total for above industries, including agriculture and mining	**2.1**

Source: PC estimates.

Reductions in the duties payable on imports also arise from a wide range of available tariff concessions. Some are available through schemes and arrangements such as those listed in the terms of reference: for example, the Manufacture in Bond scheme (MiB), the Tariff Concession System (TCS) and the Project By-Law arrangements (see chapter 6 and appendix C). Other concessions are available for prescribed persons, bodies and authorities: these include imports for diplomatic personnel and international organisations, and material for research purposes. Many tariff concessions are listed in Schedule 4 of the Australian Customs Tariff.

2.2 Budgetary revenue

In 1998-99, tariffs on goods currently under reference are estimated to have raised about $1094 million (excluding the excise component). (This amount reflects the tariff rates applicable to those goods during 1998-99. These are not necessarily the same tariff rates which currently apply.) Of this total, about $191 million (or 17 per cent) was in respect of imports covered by Tariff Concession Orders under the TCS.

Total tariff revenue collected in 1998-99 (also excluding excise) totalled about $2.9 billion. Thus, most tariff revenue was raised from goods which are not covered by this inquiry — essentially from the PMV and TCF sectors.

The percentage contribution of tariffs to Commonwealth revenue has been declining in recent years as tariff rates have declined (see figure 2.2), although there has been some steadying in the last four years. Tariffs, which contributed around 4 per cent of total Commonwealth revenue in 1986-87, are estimated to have contributed about 1.7 per cent in 1999-00 (Commonwealth of Australia 1999). On this basis, the contribution of tariff revenue collected in respect of goods under reference would be of the order of 0.7 per cent of total Commonwealth revenue.

Further, revenue from tariffs is of diminishing importance in the context of the average annual growth in Commonwealth tax revenue. In 1999-00, total Commonwealth revenue from taxation was almost $8 billion higher than the previous year (Commonwealth of Australia 2000). Over the decade to 1999-00, the annual increase in Commonwealth tax revenue averaged more than $5.3 billion.

Figure 2.2 **Total contribution of tariffs[a] to total Commonwealth revenue 1986-87 to 1999-00**

a Including all goods, but excluding the excise component of duty on imported petroleum, beer, spirits and tobacco.

Series (a) uses ABS input-output data.

Series (b) uses the data provided in the Commonwealth budget papers. These data are available only for 1998-99 and 1999-00.

Source: Commonwealth of Australia (various), ABS (unpublished data).

2.3 Bound tariffs

The reference indicates the Government's desire to 'participate in a new round of multilateral trade negotiations in which *bound* tariff reductions will be considered by Australia and other WTO members' [emphasis added].

The distinction between applied rates and bound rates is important. In broad terms, bound tariff rates are those which a country, as part of trade negotiations, commits not to exceed. More than 96 per cent of Australia's tariff subheadings are bound under WTO obligations — see table 2.3.

In Australia, the rates currently *applied* to imports are usually lower than these *bound* rates. Table 2.3 shows that the simple average bound tariff rate for manufacturing is about 6 percentage points higher than the simple average applied rate. This is in contrast to the situation in many other developed countries where applied and bound tariff duties are generally the same.

Table 2.3 **Australia's bound tariff rates[a]**

	Agriculture[b]	*Manufacturing[c]*	*Total*
Total subheadings	745	4 950	5 695
Number of bound subheadings	745	4 737	5 482
Percentage of bound subheadings	100	95.7	96.3
Simple average bound rate (%)	3.2	11.3	10.2
Simple average applied rate (%)	1.1	5.1	4.5

[a] The information about bound rates given in this table uses the version of the Customs Tariff which was current when the bindings were entered into. Thus, it differs from that used in compiling the information in table 2.1. [b] Includes chapters 1 to 24 of the Customs Tariff. [c] Includes the remaining chapters of the Customs Tariff, ie chapters 25 to 97.

Source: Based on information provided by Customs and DFAT.

The differences between average bound and applied rates vary by chapter quite markedly (see figure 2.1, where the dark infill in each bar represents this difference, with the total height of each bar representing the bound rate). In Australia's case, there is considerable scope to negotiate reductions in bound tariff rates without affecting the tariffs actually applied to imports. This is discussed in chapter 5.

2.4 Current tariff assistance

Tariffs assist local manufacturers by providing a measure of protection from import competition. In effect, tariffs enable local producers to increase the prices at which they can sell their goods on the Australian market as well as to increase the volume of those sales. (Factors such as freight on imports and the advantages of local supply can also 'protect' local manufacturers from imports.)

Assuming that manufacturers set their output prices to meet the landed duty paid price of comparable imported goods, the (gross) assistance accorded by a tariff can be measured as the proportional increase in landed duty free (ldf) prices permitted by the tariff. In contrast to practice in many other countries, Australian tariffs are expressed in terms of free on board (fob) prices, rather than ldf prices, and so the rate of assistance will be somewhat less than the tariff rate itself (see box 2.1). The rate of assistance measured in ldf terms is known as the 'nominal rate of assistance'.

Box 2.1 The nominal rate of assistance

The nominal rate of assistance is defined as the percentage change in gross returns per unit of output relative to the (hypothetical) situation of no assistance.

For example, suppose an Australian manufacturer sets its prices to meet the landed duty paid price of comparable imported goods and, without tariff, that price is equal to $100. Now suppose a tariff, expressed in fob terms, of 5 per cent is applied. Also suppose that freight and landing charges equal $10. The fob price, to which the tariff applies, is thus $90. Then, with tariff, the landed duty paid price will be $(100 + 90*5%), or $104.50. Thus, the nominal rate of assistance (ie the duty expressed in ldf terms) is 4.5 per cent.

When comparing the tariff rates of different countries, care needs to be taken to ensure that they are expressed on the same basis, preferably in ldf terms.

As noted above, preferential tariff rates and tariff concessions may reduce the levels of tariff which apply. For example, for a particular tariff item, goods from some countries may be dutiable at the general rate of 5 per cent (in fob terms) and from other countries at preferential rates of Free or 4 per cent. Similarly, tariff concessions may reduce the applicable rate of duty on particular goods to Free or to 3 per cent. Thus, although a substantive general rate of 5 per cent may apply to a particular tariff subheading, the average duty rate paid in respect of imports under that subheading, in fob terms or in ldf terms, may be significantly lower than if all imports were to enter at the 5 per cent rate. The last column of table 2.4 shows that the import-weighted average tariff rates (in ldf terms) for goods under reference are generally well below that level, with the average being only 3.2 per cent. Although part of the difference is due to the translation of fob tariff rates to ldf terms, most is due to the effect of preferential and concessional imports. The table also shows the assistance-reducing effect on particular industries of duty free imports.

Despite preferential tariffs, however, the level of nominal assistance available to local producers may not necessarily be lower than that which would be available if all competitive imports from preferential sources entered at general tariff rates. This depends on the pricing strategies adopted by importers: in particular, whether market conditions allow them to increase their profit margins by marking up to the landed duty paid prices of comparable imports from general rate countries, or whether they undercut those prices.

A number of factors can influence the pricing strategies adopted by importers from preferential tariff countries. These include: the extent of product differentiation between imports from different countries and between imports and Australian produced goods; relative cost structures; the strength of competition in the Australian market; total import share and the shares from different countries; the number of importers from different countries; and ownership links (if any) between importers and Australian producers.

Table 2.4 **Import-weighted average tariff rates by ANZSIC industry**
per cent in ldf terms, 1998-99 values

ANZSIC industry	*Average including duty free imports*	*Average excluding duty free imports (ie the average for goods under reference)*
Agriculture, forestry, fishing and hunting	0.2	5.6[a]
Mining	0.0	0.0
Manufacturing		
Food, beverages and tobacco	1.6	3.5
Wood and paper products	1.9	2.6
Printing, publishing and recorded media	0.5	3.7
Petroleum, coal, chemical and associated products	1.5	3.4
Non-metallic mineral products	3.2	3.7
Basic metal products	1.1	2.7
Fabricated metal products	3.2	3.6
Other vehicles	0.2	2.7
Other machinery and equipment	1.4	3.2
Other manufacturing	2.4	2.9
Other and unspecified	0.0[a]	1.8
Total for above industries including agriculture and mining	**1.3**	**3.2**

[a] Affected by rounding error.

Source: PC estimates.

For goods under reference, it is likely that the main effect of preferential tariffs for particular countries is to divert trade to those countries, rather than to lower the average after-tariff price of imports. This is because these countries (including New Zealand, Papua New Guinea, the Forum Island and some developing countries) either have a cost structure similar to Australia's or suffer a trade disadvantage not typical of most countries exporting to Australia.

Typically, firms produce a range of products depending on the industry in which they operate. Each product may be affected differently by the assistance structure — for example, some receive protection from general tariffs of 5 per cent, whereas others receive no protection from imports. Production-weighted nominal rates of assistance on output provide an indication of the overall assistance effect of tariffs on the outputs of particular industries and industry sectors. The estimates shown in table 2.5 assume that imports from preferential rate sources do not reduce assistance available to Australian producers.

However, the assistance on outputs arising from general tariffs may be reduced if, as is usual, local producers suffer from the taxing effect of tariffs on the inputs they use. Indeed, conceptually, the assistance from tariff protection on outputs may be eliminated or even outweighed by tariffs on inputs used. The net effect of assistance on inputs and outputs, expressed as a proportion of unassisted value added, is known as the 'effective rate of assistance' (see box 2.2). Table 2.5 shows average nominal and effective rates for a range of industry groups. For manufacturing industries supported by the tariffs under reference, the average effective rate of assistance is 3 per cent.

Table 2.5 **Average nominal and effective rates of assistance, agriculture (1997-98) and manufacturing (2000-01)[a, b]**

per cent

Sector	*Nominal rate on inputs*	*Nominal rate on outputs*	*Effective rate*
Agriculture	**na**	**3**	**8**
Manufacturing			
Food, beverages and tobacco	3	3	2
Textiles	2	6	17
Clothing and footwear	7	19	34
Wood, wood products and furniture	3	4	4
Paper, paper products, printing and publishing	2	2	2
Chemical, petroleum and coal products	..	1	3
Non-metallic mineral products	1	1	2
Basic metal products	1	2	4
Fabricated metal products	4	4	4
Transport equipment	6	9	13
Other machinery and equipment	3	4	5
Miscellaneous manufacturing	3	5	7
Total manufacturing	**2**	**3**	**5**
Manufacturing (excluding PMV and TCF)	1	2	3
PMV	6	11	20
TCF	4	11	26

na Not available.

[a] Estimates for agriculture are not strictly comparable with those for manufacturing. [b] These estimates are not strictly comparable with those given in table 4.5.

Source: PC (1999c) and PC estimates.

The information given in the table allows the magnitude of possible further general tariff reductions to be put into perspective. Aside from the effects of the tariffs remaining on the PMV and TCF sectors, a reduction in general tariffs to Free would result in an average reduction in value added for the chemical, petroleum and coal products sector, for example, of about 3 percentage points.

Box 2.2 **The effective rate of assistance**

In broad terms, the effective rate of assistance is defined as the percentage change in value added due to the assistance structure.

Starting with the example in box 2.1, also assume that the cost of inputs is $50 and that no tariffs apply to those inputs. In this case, unassisted value added is $50. So the increase in output price enabled by the tariff on outputs of $4.50 adds to this to give assisted value added of $54.50, an effective rate of 9 per cent.

Now suppose that an (fob) tariff of 5 per cent applies on average to inputs, which also have an fob/ldf ratio of 0.9. This tariff on inputs has a taxing effect of $2.25, reducing overall assisted value added to $52.25. The effective rate now is 4.5 per cent, equal to both the nominal rate on outputs, and the nominal rate on inputs.

Several participants (see section 6.2) described situations where the tariff on outputs was Free while inputs were taxed at 3 per cent. Under the above assumptions, this would result in a reduction in value added, giving an effective rate of minus 2.7 per cent.

2.5 Tariff reform to date

Since the early 1970s, Australia's average tariff levels have been reduced, both through a series of across-the-board measures and as the result of inquiries into particular industries and commodities (see box 2.3). This is despite very large increases in assistance to the PMV and TCF sectors during the mid-1970s to mid-1980s.

Tariff reductions over the period have brought significant reductions in levels of nominal and effective assistance to import-competing industries. For example, the average effective rate for the manufacturing sector has declined from 35 per cent in 1972-73 to about 5 per cent for 2000-01 (see figure 2.3).

Box 2.3 **Milestones and detours along the road to lower tariffs**

In 1971, the Government announced a program of review of tariffs by the Tariff Board. The Government was careful to point out, however, that this would involve no commitment on its part to implement any recommendations made.

In 1973, tariffs were reduced across the board by 25 per cent. In later public discussions, increases in unemployment were attributed primarily to the tariff cuts, against the evidence of analytical studies. Further across-the-board reductions were seen as politically difficult.

Consequently, there was a return to the piecemeal approach. Non-tariff measures gained favour in response to increasing unemployment. Market sharing through import quotas was introduced as a 'temporary' measure in the mid-1970s, mostly in highly assisted industries. (In two cases, they were not removed until 1988 (Automotive) and 1993 (TCF).)

In 1982, the Government announced that general reductions in protection were precluded for the time being.

Governments adopted a broader industry-wide approach to reviewing industry assistance from the early 1980s. Industry plans were introduced in some industries from 1983. While some elements of these plans were questioned in some quarters, they attempted to establish greater uniformity in assistance, improve intra-industry efficiency and instil an export focus. The Government increasingly determined industry development measures on a generic basis — for example, generally available encouragement of research and development.

An agreement for Closer Economic Relations between Australia and New Zealand was introduced in late 1982. It established a progressive move toward free trade in most goods between the two countries at 1 July 1987.

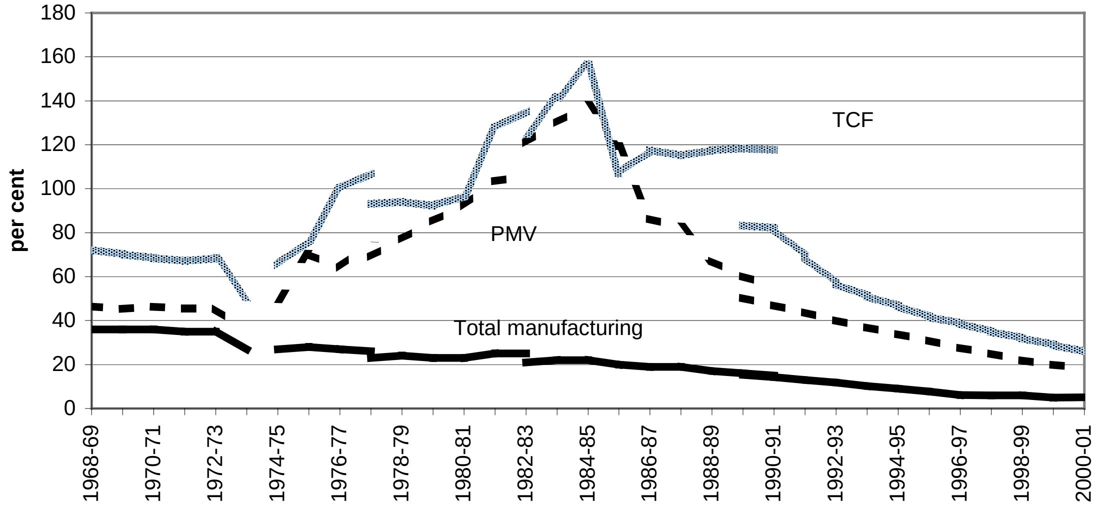
In 1988, the Government announced a four-year program of phased reductions in nominal tariff rates for most imports (excluding the PMV and TCF sectors). Tariffs above 15 per cent were to be phased down to 15 per cent and those between 10 per cent and 15 per cent were to be phased down to 10 per cent.

In 1991, the Government announced the continuation of this program of phased tariff reductions. General tariffs were to be phased down to 5 per cent over the four years to July 1996. Tariffs on passenger motor vehicles were to be phased down from 35 per cent in 1992 to 15 per cent in 2000. Tariffs on textiles, clothing and footwear were to be phased down to a maximum rate of 25 per cent by 2000.

In 1997, the Government announced that tariffs in the textiles, clothing and footwear industries and the automotive industries were to be frozen at their year 2000 levels until a further reduction in 2005. The Government also announced packages of non-tariff measures covering these industries (see section 4.2).

Source: PC (1999b).

Figure 2.3 **Effective rates of assistance, 1968-69 to 2000-01**



Source: PC estimates.

However, progress over the period has not always been smooth, as the box and figure show. Further, other than for the PMV and TCF sectors, there have been no systematic reductions since July 1996. Subsequent chapters in this report explore the scope for further reductions in tariffs on the goods under reference in this inquiry.

3 Tariffs and their effects

In the past, Australia's tariffs on imports were high and disparate. Since 1988, there has been a substantial phased reduction of tariffs. While not all tariff-assisted industries have prospered, this has brought substantial ongoing net benefits to the Australian community.[1] The levels and dispersion of tariffs protecting the textiles, clothing and footwear (TCF), and passenger motor vehicle (PMV) industries have also been reduced substantially. However, at maximums until 2005 of 25 per cent and 15 per cent, respectively, their tariffs remain many times the maximum 5 per cent provided to other industries.

As requested in the terms of reference, there is a need to consider the possible effects of a further reduction in the tariffs under reference on consumers, industries and their employees and the general community. This is the focus of this chapter.

The economic effects of tariffs are outlined in the next section. This is followed in section 3.2 with an indication of the potential magnitude of the effects of further reductions in tariffs under reference as provided by participants and by the Commission's own quantitative analysis. Then, in section 3.3, the employment effects estimated to result from the removal of tariffs under reference are compared with past changes in regional employment to illustrate the potential scale and spatial dimension of adjustment. The results of an approximate estimate of the likely costs of the additional adjustment in the labour market associated with tariff reductions are also presented. Adjustment issues are discussed further in chapters 4 and 7.

3.1 Effects of tariffs

The focus of this section is on the effect of tariffs on prices. As indicated by some participants, including Australian Business Limited (ABL) (sub. D131, p. 4), however, price is only one of many attributes which affect demand for and supply of products. Others include quality, innovation, timely service to customers,

[1] A summary of the historical evolution of protection policy in Australia was provided by the Industries Assistance Commission in its report on *Approaches to General Reductions in Protection* (IAC 1982a, section 2.1). The Commission also has provided estimates of the benefits of the across-the-board tariff reductions made since the mid-1980s (IAC 1988a, appendix 2; IC 1991a).

management and marketing competence. Each of these, to varying degrees, can substitute for price.

Direct and indirect effects of tariffs

Trade provides opportunities for mutually beneficial exchanges between countries. Tariffs, by limiting such opportunities, reduce a country's opportunities to exploit its comparative advantages in production. Thus, there is a presumption that lowering tariffs will improve a country's welfare. Arguments for tariffs which may qualify that presumption are discussed later in this section.

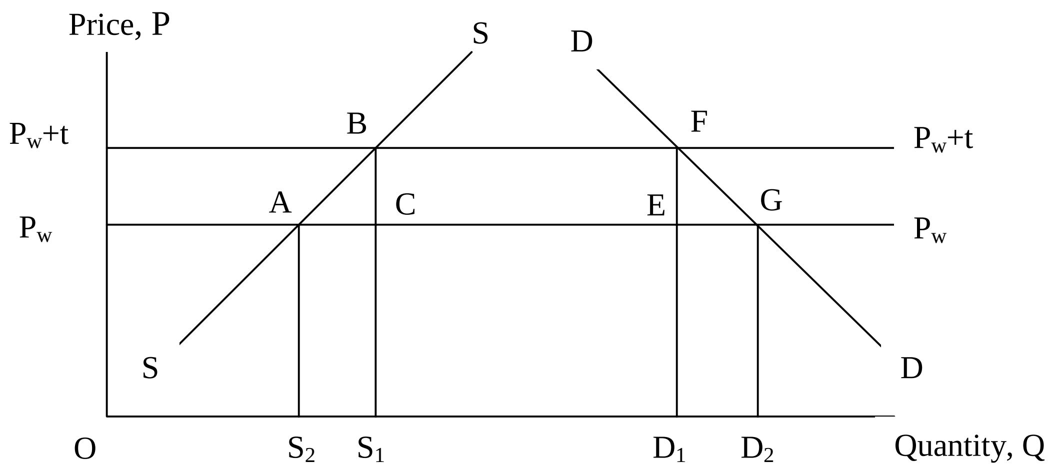
Tariffs are a tax on imports, intended to raise the price of imported goods to levels at which domestic producers are more competitive with imports. They assist some domestic producers, but increase prices paid by domestic users and consumers for goods subject to tariffs (whether they are imported or produced locally) and reduce the consumption of those products. Tariffs can also reduce consumer choice, and investment opportunities, by restricting the range of products available in domestic markets.

It follows that removal of tariffs reduces prices of imports subject to them, and prices of domestically produced substitutes. In principle, this enhances the income of consumers and increases the profitability of user industries on the one hand, while on the other it directly reduces the profitability of the industries assisted by the tariff. Removal of tariffs also reduces government revenue. These direct, or 'static', price-induced effects of a tariff in a small country such as Australia are illustrated in box 3.1, which also shows conceptually the gains in allocative efficiency associated with tariff removal. Empirical analysis is required to estimate the extent of any such gains, after taking into account the effects of fiscal measures (eg different types of taxes) to replace the forgone tariff revenue.

The increased consumer income from lower tariffs expands household demand for goods and services, which in turn expands the demand for new investment and labour to supply additional goods and services. Previous analyses of the direct taxing effect of tariffs included estimates for 2000-01 (IC 1991a). These estimates indicated that reduction of all tariffs from their present level to zero would directly reduce the cost of household expenditure by 1.3 per cent — with approximately half of the total being derived from the tariffs under reference and the balance from removal of TCF and PMV protection (IC 1990, Appendix 12).

On the production side, the increased profitability for user industries arising from lower tariffs encourages new investment to expand output. This increases the number of jobs they can provide and increases demand for intermediate inputs from supplier industries. Conversely, the reduced profitability of protected industries acts to reduce their investment and production, demand for inputs from supplier industries and the number of jobs they can provide. In turn, the reduced incomes of displaced workers while they seek new employment or withdraw from the workforce add to adjustment costs and detract from the overall growth in demand for goods and services. Some of the displaced workers add directly to the number of unemployed and increase the demand for social services.

Box 3.1 **Effects of tariffs in a small country**



In the diagram, the domestic demand curve for the product is DD, the foreign supply curve for imports of the product is P_wP_w and the supply curve for domestic import-competing producers is SS. A tariff on the product raises the import supply curve to P_w+tP_w+t. With a tariff on the product, domestic production would be OS_1, consumption would be OD_1 and the excess of consumption over domestic production, S_1D_1, would be imports. The cost of the imports would be CED_1S_1 and the customs duty collected on them BFEC.

With removal of the tariff, the consumer surplus gain would be P_w+tFGP_w. Of this gain, P_w+tFEP_w would be the income gain from a lower price to existing consumers and FGE would be the efficiency gain from additional consumption by existing and new consumers. Domestic producers would lose P_w+tBCP_w, of which P_w+tBAP_w would be a loss of producers surplus and BCA an efficiency gain as resources are moved to less assisted activities elsewhere in the economy. Imports would expand to S_2D_2 and the government would have to replace the forgone customs revenue, rectangle BFEC, with another source of revenue.

The total efficiency gain is the sum of the two triangles — FGE, the consumption efficiency gain and BCA, the production efficiency gain. The magnitude of the efficiency gain from removal of the tariff would depend on the height of the tariff, t, and the slopes (elasticities) of the demand curve and domestic producers' supply curve.

Where a sales tax, such as a wholesale sales tax or GST is also applied, the consumption efficiency gain from removing the tariff would be much larger. This is because the price to consumers would include the combined effect of the tariff and the sales tax. Removal of the tariff, while the sales tax is left in place, would involve the same production efficiency gain, plus a significantly larger consumption efficiency gain.

The price changes induced by tariff reductions increase productivity and national income. As a result, new jobs are created indirectly over time throughout the economy, replacing those lost in industries previously assisted by tariffs. Such indirect job creation is often overlooked in discussion of the effects of tariffs, as the link between the new investment and jobs and reduced tariffs, via increased community income, is not as obvious as that between reduced protection and lay-offs in adversely affected industries.

Because of these more obvious effects, tariff protection is often thought to be a means of maintaining (or even increasing) the level of employment. However, it has long been recognised that tariffs do not have any significant impact on the total level of employment in the economy as a whole. The employment and investment assisted by tariffs in some industries come at the expense of employment and investment in other existing and new industries whose development is hindered by tariff protection. Krugman (1996) put the point as follows:

> … the level of employment is a macroeconomic issue, depending in the short run on aggregate demand and depending in the long run on the natural rate of unemployment, with microeconomic policies like tariffs having little net effect. Trade policy should be debated in terms of its impact on efficiency, not in terms of phony numbers about jobs created or lost. (p. 123) [2]

Removal of tariffs encourages more imports and leads initially to an increase in the current account deficit. In turn, this is likely to put downward pressure on the nominal exchange rate and some upward pressure on domestic inflation. The result is an increase in the international competitiveness of export and import-competing industries generally, encouraging their expansion. This also helps to offset the effects of the removal of tariffs on the formerly assisted industries.

Because tariffs are also a source of revenue for government, their removal requires an increase in other taxes (or a reduction in government expenditure) if fiscal balance is to be maintained. In this context, what matters is whether the replacement fiscal measures can be implemented at more or less cost to the community than the tariff revenue.

In addition to the direct and indirect 'static' effects of removing tariffs on imports, there can also be pervasive continuing effects on the behaviour of firms operating in a more competitive marketplace. These 'dynamic' effects can have implications for

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2 This view is supported by a recent econometric analysis of Australia's unemployment record since the 1970s in which the overall rate of unemployment was decomposed into macroeconomic and sectoral components (Heaton and Oslington 1999). The preliminary analysis indicates that the major part of the changes in aggregate unemployment resulted from macroeconomic 'shocks' and that sectoral 'shocks' accounted for around 21 per cent of the variation in unemployment. Of the 21 per cent, less than 3 percentage points were contributed by the manufacturing sector — the sector most directly affected by changes in tariffs and other forms of import protection over that period.

the rate of economic growth, as distinct from the once-for-all increase in its level which typically stems from the ‘static’ improvement in resource allocation.

Dynamic effects can occur as firms, more exposed to international competition and innovation, have more opportunity — and are under more pressure — to acquire improved knowledge of their markets and of the best production and management techniques. They may be induced, for example, to undertake more effective research and development, to adopt new technology in order to improve productivity, or to improve their marketing skills. The change in the tariff policy environment may alter firms’ expectations of the availability of government support and result in greater attention to improved management of business operations.

These dynamic effects are very difficult to measure, but that does not diminish their presence or importance. By improving overall productivity growth, such dynamic effects enhance community welfare more generally. An additional aspect of these dynamics is that reform in one area, such as tariffs, can provide an impetus for reform in other areas, which can mean the eventual effects are magnified.

Professor Ross Garnaut considered that the gains from such dynamic effects of tariff reforms tend to be underestimated, in part because of the expansion of increased specialisation and intra-industry trade:

> The processes through which these additional gains are generated are subtle, and not amenable to precise measurement, but they are widely recognised by analysts of the process of economic development. … Rather, there are additional gains that in their nature cannot be incorporated into quantitative economic models in a convincing way in the current state of art. (sub. D164, p. 1)

He added:

> …While the improvement of Australian economic performance in recent times has many proximate causes, to a significant extent the other proximate cases have been driven by Australian economic decision-makers at every level in society realising that they are operating in an international market, and that world class performance is necessary for success in this environment. The move towards free trade has been crucial to this transformation of perceptions.
>
> The removal of the last remaining tariffs on the goods under reference would further strengthen the perception that world class performance was necessary for economic success in Australia, amongst other things by strengthening the perceptions that the protection policy changes of recent decades were irreversible. (sub. D164, p. 1)

The removal of discriminatory measures, such as tariffs, can be viewed as contributing in a wider context to the adoption of universal institutional arrangements which are more conducive to community welfare and prosperity (Kasper and Streit 1998). This includes establishing and maintaining institutional arrangements which reduce transactions costs by providing clear and predictable rules; rules that are general and which avoid as far as possible specific discrimination among activities, businesses and people; and open rules that can give guidance to as yet unknown future situations.

Tariff administration and compliance

Raising tariff revenue involves administrative and compliance costs associated with ensuring the integrity of the duty collection system. On the one hand, the Australian Customs Service (Customs) incurs costs to ensure that importers correctly classify and value items for duty. On the other, importers incur costs to comply with the law and to ensure that they avoid unnecessary duties, penalties and delays.

The reductions in levels and numbers of operative rates, which occurred over the decade to mid-1996, are likely to have reduced costs associated with duty collection considerably. However, preferential and concessional arrangements which modify the application of general rates (such as developing country preferences and the Tariff Concession System) add significantly to administrative and compliance costs. An indication of some of those costs is provided in chapter 6.

From 1 July 2000, the new Goods and Services Tax (GST) has applied to both domestically produced and imported goods. Its introduction has neither advantaged, nor disadvantaged, domestic producers relative to importers. However, because the GST applies to the landed duty paid value of nearly all imports, whereas Australian tariffs typically apply to the free-on-board value, importing involves the collection of two taxes on different bases. This adds to the administration and compliance costs of importing. On the other hand, the replacement of the wholesale sales tax by the GST is of substantial benefit to Australian exporters, who no longer pay tax on their inputs.

Arguments for tariffs

The costs arising from the removal of tariffs are typically concentrated and can be relatively large for those adversely affected, whereas the benefits, while cumulatively larger and more widespread, are individually small. In such circumstances, the interests of particular groups can override the national welfare considerations which emerge from an economy-wide assessment of all the benefits and costs.[3]

[3] An outline and analytical summary of such political economy considerations is provided by Vousden (1990, part III).

There are, however, a number of arguments for tariffs other than the desire to assist some selected industries (and the jobs and investment reliant on them) at the expense of others and the community overall. In general, the arguments rely on the identification of some form of market failure in the economy and the proposition that overall economic welfare can be improved by the imposition of tariffs. In this regard, the questions which need to be answered are:

- are tariffs superior to measures which directly address the identified market failure?; and
- do the benefits of using tariffs exceed the costs?

The generalised theoretical framework for the consideration of these sorts of issues, first provided by Bhagwati (1971), is still considered relevant to the new issues which have arisen since then (Srinivasan 1995). An extensive application of that framework to economic and non-economic arguments for tariffs has been provided by Corden (1974, 1997) and Krugman and Obstfeld (1994). In general, they show that, as a means of correcting domestic market failures, tariffs are inferior to measures which directly target the source of that failure. This is because tariffs always involve both consumption and production distortions whereas market failures typically involve only either a consumption distortion or a production distortion.

Arguments which have been put forward in defence of tariffs include:

- the influence on export and import prices (ie terms of trade effects);
- the ability of Australian-based firms to capture profits in some industries at the expense of overseas producers (ie so-called strategic trade theory);
- the ability to reduce the costs of uncertainty associated with movements of exchange rates;
- promotion of the efficient development of new (infant) industries; and
- the provision of strategic benefits for Australia's defence effort.

Terms of trade and tariffs

As pointed out by the AIG (sub. 63, p. 8), a traditional argument against a move to free trade is the idea of an 'optimal tariff' based on government intervention to influence favourably a country's terms of trade. According to the argument, removal of tariffs could worsen the terms of trade.

Other things being equal and in circumstances where a country's volume of exports is significant in world terms and demand for them is less than infinite, the additional exports from increased trade associated with the removal of trade restrictions, such as tariffs, could act to depress export prices. Likewise, additional imports purchased by a country which accounts for a substantial part of global demand could act to increase import prices. As a result, the ratio of these two price effects — the terms of trade — could decline. This means that, at some point, the consumption and production efficiency gains from removing tariffs could be outweighed by price effects — the terms of trade loss. Hence, in theory, in these circumstances, there could be a positive level of optimal trade intervention, the so-called 'optimal tariff'.

The terms of trade effect is of limited practical relevance to tariff policy in Australia. This is because Australia accounts for a small share of most areas of world trade and has little, if any, capacity to influence world prices (especially of its imports). As Caves and Jones (1977) have observed, 'for a small country that cannot influence the world prices of what it buys and sells, the optimal tariff is zero'. Even for products where Australia supplies a significant share of world markets, it is unlikely that the government could obtain a terms of trade gain by imposing, or retaining, tariffs. This is because the industries involved typically have an oligopolistic structure with few exporters. Hence, price responsiveness considerations are an integral part of their overseas marketing operations. Also, in principle, tariffs on imports would be a much less efficient form of intervention than selective export taxes.

Strategic trade theory

Much of traditional trade theory is based on an assumption of competition between many buyers and sellers individually unable to influence market prices. These conditions do not always apply. In the 1980s, specific consideration was given to possible implications of oligopolistic industry structures and strategic interactions among a few firms. Some argued that, with government intervention in trade in oligopolistic markets, it might be possible to shift profits from a foreign firm to its domestic competitor, with a resultant net increase in national income — at least if there was no foreign government retaliation (Brander and Spencer 1984, 1985).

The strategic trade possibilities of this 'new international economics' were popularised by Krugman (1986, 1987). However, as the possibilities were explored, the limitations on the scope for governments to intervene beneficially on such grounds became more evident. This led Corden (1997) to observe that:

> Krugman (1986, 1987) propagated the term 'new international economics' for these [industrial organisation and trade theory] and other developments and rather overdramatized their significance, notably in the much cited Krugman (1987) article. But, … in his major textbook — Krugman and Obstfeld (1994) — … there is a very balanced and skeptical discussion of the case for industrial policy. (p. 254)

Helpman and Krugman (1989) noted that a key question about the new trade theory was whether it gave rise to any systematic new argument against free trade. Their answer was ‘no’ on the grounds that:

> The case for free trade has always rested on an argument that it represents a good rule of thumb given uncertainty about alternatives, realistic appreciation of the difficulties of managing political interventions, and the need to avoid trade wars. (p. 186)

The issues raised by strategic trade theory emphasise the importance of considering market structure when seeking to assess the effects of removing tariffs. For example, the existence of oligopolistic domestic industry structures usually reflects economies of scale in the industries concerned. In many instances, this tends to strengthen the case for free trade as is evidenced by the quantitative general equilibrium modelling by Harris and Cox (1984) which suggests that economies of scale can substantially increase the gains from trade. Furthermore, a recent analysis of the labour productivity performance of a sample of Australian manufacturing firms over the period 1984 to 1993 by Bloch and McDonald (2000) indicated that import competition interacts with domestic competition in influencing productivity performance. They found that, where domestic industry concentration exceeds some minimal level, the higher the degree of industry concentration, the greater the improvement in productivity associated with increased exposure to import competition.

Uncertainty and tariffs

The AIG drew the Commission’s attention to its survey of literature on exchange rate uncertainty and optimal tariffs. It held that:

> In summary, the literature on tariffs under uncertainty shows that, where import-competing firms face uncertainty associated with fluctuations in the exchange rate or the terms of trade, and where the markets for financial assets to manage risk are incomplete or imperfect, tariffs may increase economic welfare. In general, there may exist alternative policy instruments which may yield the same risk-management benefits at a lower efficiency cost. (sub. 63 p. 28)

The AIG considered it unlikely that the efficiency benefits of alternative instruments would be sufficient to offset the administrative and adjustment costs of their adoption. Accordingly, as it considered that the efficiency costs of retaining the existing tariffs under reference are minimal, it argued that exchange rate uncertainty supports a continuation of the existing tariffs.

Capital markets and risk management techniques already provide a wide range of market instruments and business strategies for firms to manage operating risks. There is a separate issue as to whether managers of some firms have a good understanding of such instruments and strategies. For example, when asked about the adequacy of capital markets in this regard at the draft report hearings, Kaal Australia Pty Ltd replied that ‘All the instruments are there that you may wish to avail yourself of’ and that remaining issues revolve around the robustness of firms’ own decision-making processes (DR trans., p. 25). The relevant question is not whether the existing tariffs could provide risk management benefits, but whether they would provide any additional benefits (in terms of dealing with exchange rate uncertainty) over and above those that already exist which could justify their efficiency costs.

In contrast to the theoretical point made by AIG about exchange-rate uncertainty and tariffs, Stoeckel, Tang and McKibbin (1999) suggested that there is evidence of a relationship between the openness of an economy and lower risk premiums for a country as a destination for investment. They used this information to show how lowering tariffs can provide additional benefits by reducing uncertainty among investors.

Infant industry development

The NSW Farmers’ Association raised infant industry development as a possible reason to retain the existing tariffs in some industry sectors, subject to case-by-case evaluation:

> The Association supports the development of new and sustainable industries and therefore recognises that there might be a need for the preservation of the general tariff within certain industries. However, the onus of proof must lie with the particular business or industry to show the retention of the tariff for that particular industry is in the national interest, ie that the benefits outweigh the total cost. (sub. 77, p. 7)

Critics of the infant industry argument have not only contested whether such market failures exist in the practical sense that they can be offset in a cost-efficient manner by tariffs, but also point to a danger of providing such assistance — that the investment and employment becomes predicated on a continuation of the assistance (ie infants fail to ‘grow up’). Also, evidence from the last three decades of the growth and development of manufacturing — the main sector to derive assistance from tariffs — shows that higher than average growth has occurred where lower than average assistance has been provided (Chand et al. 1998).

Defence capability

The AIG drew the Commission’s attention to the possible defence benefits of protecting manufacturing capability in Australia. It said:

> When calculating the costs and benefits of such a reduction [that is of the tariffs under reference], it is essential to consider the strategic implications for Australia of a possible diminution in our manufacturing base, not just the economic impact. (sub. 63, p. 80)

Australian defence policy emphasises self-reliance and part of this involves developing a long-term, effective and dynamic partnership between Defence and Australian industry (Department of Defence 1994, chapter 11). However, the existence of such a partnership does not necessarily imply that defence capability is enhanced by tariff protection of particular industries or manufacturing as a whole. When outlining industry's role in supporting defence capability in its discussion paper for the Defence Review 2000, the Department of Defence (2000) said:

> The ADF [Australian Defence Forces] requires support from industry and infrastructure across the spectrum of likely operational circumstance. … size and organic resource limitations would only become pronounced in responding to a major conflict on Australian soil. … Inherent in this [relationship between Defence and providers of national industrial resources] is exploring the functions the ADF should carry out and the issues of contractor support to operations, including the premium payable for having this kind of support. (p. 35)

Accordingly, Defence planners explore all possible means by which defence capability may be achieved. For example, for some items, emergency stockpiles may be a cheaper means of keeping defence capability than protecting industries from international competition in peacetime on the basis of possible linkages to production of defence goods. Also, protection of certain industries on the ground that they have the capability to produce defence goods is clearly inferior to allocating funds and allowing military authorities to determine the minimum-cost ways of attaining defence objectives. The latter approach avoids the added costs to other users. Moreover, as noted in the Defence Review 2000 discussion paper, 'A strong national economy can contribute very effectively through augmenting the Defence resources available to respond to threats to our national interest' (Defence 2000, p. 35).

Some defence projects may be of such high strategic priority that there are sufficient grounds for paying a higher price for Australian production rather than having to rely on an overseas supplier. In its report on *Defence Procurement*, the Industry Commission (1994) considered that Defence should be wary of paying premiums for Australian supply and endorsed the then current policy that 'Australia's general strategy will be to avoid them as far as possible' (Defence 1993, p. 71). The Commission discussed how such premiums could be established so that Defence would be better able to justify the additional costs against the strategic benefits.

In summary, the practical significance of the various arguments advanced in support of tariffs is limited. At least conceptually, a reduction of tariffs is likely to improve welfare. It needs to be borne in mind that the maximum tariff under consideration is small — essentially 5 per cent. The average effective rate of assistance on value added is only 3 per cent. The tariffs assist a range of manufacturing activities which in total contribute some 10 per cent to gross domestic product. As the tariffs are already low and relatively uniform, the extent of any gains from their removal is likely to be small relative to the across-the-board tariff reductions which occurred in the past.

Tariffs and the floating exchange rate

The terms of reference request that, in formulating options and implementation strategies, the Commission take into account the impact of the floating exchange rate on the competitiveness of Australian industry. This raises the question of the influence of the tariffs under reference relative to exchange rate movements in the determination of industry competitiveness.

The advantage of the floating exchange rate is that, if appropriate monetary and fiscal policies are maintained, costs and prices in Australia relative to those overseas are more likely to reflect underlying differences in competitiveness. This means that exchange rate movements are more likely to bring about changes in the allocation of resources which are beneficial to the community overall, while avoiding balance of payments problems.

An indication of the significance for manufacturers of changes in the exchange rate relative to the tariffs under reference is provided in box 3.2. Notwithstanding the limitations of the measures used, and the fact that a lower exchange rate raises the cost of imported inputs, the influence on competitiveness of Australian industry of the existing tariffs is small relative to the changes in competitiveness that occur as a result of exchange rate changes. Drawing on exchange rate data, the ABS index of price for manufactured imports and the Treasury indicators of competitiveness, DFAT reached the same conclusion (sub. 65, pp. 26–8).

3.2 Quantifying the effects of removing existing tariffs

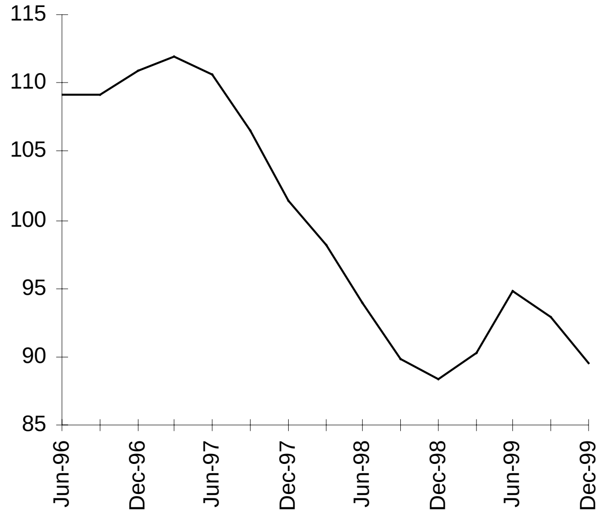
Most participants from the manufacturing sector pointed to the direct benefits that the existing tariffs under reference provide in terms of assistance for sale of their outputs in the domestic market against foreign competition (see box 3.3). Some indicated the importance of the existing tariffs to their investment, output and employment plans.

Box 3.2 **An indication of the influence of changes in the exchange rate on manufacturing industry competitiveness**

In the period from July 1996 to early 2000, there has been no change in the assistance provided to manufacturing industry by the tariffs under reference. The tariffs provided an average effective rate of assistance of 3 per cent and ranged at an industry level from 2 per cent to 7 per cent.

Index of industry competitiveness[a], June 1996 to December 1999

1997-98=100[b]



[a] Exchange-rate adjusted index based on the implicit price deflators of Australia and its four major trading partners. [b] A fall in the competitiveness index signals an improvement in Australia's competitiveness.

The Treasury publishes three indicators of competitiveness which adjust for inflation. These exchange-rate adjusted indexes are based on non-farm unit labour costs, consumer prices and implicit price deflators, respectively, in Australia and its four major trading partners.

All three indicators show similar increases in industry competitiveness over the period from the June quarter 1996 to the December quarter 1999 of around 18 per cent and variations in competitiveness within the period of around 22 percentage points.

Thus, exchange rate changes can be quite important, relative to tariff assistance, in determining aggregate industry competitiveness. However, when interpreting the results of such indicators, their limitations need to be kept in mind.

While international prices influence domestic prices, they do not fully determine them. This limitation is perhaps more serious for manufacturing inputs than manufacturing outputs. This is because they are likely to include relatively more non-tradeable goods and services. Non-tradeable goods and services prices reflect domestic supply and demand conditions. This means that the indicators may overstate the effect of exchange rate changes on industry competitiveness. In addition, DFAT (sub. 65, p. 26) pointed to the work of Phillips (1991) which suggests that the effects of import price changes resulting from exchange rate changes are moderated in the short term by importers and retailers absorbing a somewhat higher proportion of the change they experience.

Also, the international prices of relevance to the competitiveness of a particular industry may differ from the broad averages used in the indexes.

Source: Treasury, *Economic Roundup* (various issues).

Quantitative estimates of the overall gains from further trade liberalisation were provided to the Commission by DFAT (sub. 65), AIG (sub. 63) and ABL (sub. D131). DFAT pointed to research it had commissioned by the Centre for International Economics and Professor Warwick McKibbin which suggested that:

Over the longer term, further gains from a move to zero tariffs would be around 1 per cent of GDP, well in excess of gains to Australia from liberalisation by other economies in our major Asia Pacific markets.

These results generally understate the gains. Most modelling work which has been undertaken does not fully take into account the dynamic gains from trade liberalisation, particularly the way in which heightened competition can induce increases in productivity. As suggested already, experience with trade liberalisation suggests that industries often adapt to cuts in protection much more successfully than would have been predicted, lifting productivity sharply in the process. (sub. 65, p. 11)

Box 3.3 **Some arguments for general tariffs**

AustralChem:

> Should pricing pressure from imports increase to the point that would cause the demise of AustralChem as a local producer, this would result in a further contraction of Australia's already shrinking manufacturing base. The consequence would be the retrenchment of another workforce in the Newcastle region … (sub. 78, p. 1)

BHP:

> Further reductions in tariff levels … will impose added pressure on the Australian steel industry … would add to the difficulties of … restructure. (sub. 57, p. 6)

Huntsman:

> The consequences of eliminating import tariffs are significant … It will reduce profitability and reduce investment in manufacturing capacity and productivity improvement. This will threaten the viability of chemical manufacturing plants … (sub. 35, p. 1)

Kaal Australia:

> 5% tariff can mean the difference between an adequate return and a loss. (sub. 19, p. 2).

National Furnishing Industry Association:

> … reduction in tariffs prior to the achievement [of the Furnishing Industry Action Agenda] outcomes will result in a significant reduction in the size and capacity of the Australian Furnishing Industry. (sub. 28, p. 2)

Qenos:

> As our competition is fully imported a reduction in the tariff on chemical products by 5% would drive an immediate reduction of that magnitude in our pricing. This would cost our business in the order of A$25 million … [This] represents roughly half of our current annual business earnings … in the near term [it] would necessitate the re-examination of the viability of all of our business units. (sub. 26, p. 2)

Volvo Truck Australia Pty Ltd:

> Under the present tariff arrangement CBUs attract 5% import duty. Should the government ultimately decide to implement a reduction in the general rate of duty … CBU importers would reduce their current import duty costs by several thousand dollars per vehicle ... as a result … the truck assembly industry would be unable to compete with the CBU importers … and would be forced into closure. (sub. 52, p. 2)

The DFAT estimates relate to the gains from removing all remaining tariff assistance — ie that provided to the TCF and PMV industries as well as the tariffs under reference. The finding that the major benefits of multilateral trade liberalisation to a country derive from its own liberalisation efforts supports unilateral action. The trade policy aspects are discussed in chapter 5.

In contrast to the findings of work commissioned by DFAT, the AIG, focusing on the tariffs under reference, drew on work it commissioned by Professor John Quiggin which held that:

> The static neoclassical model yields the estimate that a move from a 5 per cent uniform tariff to zero yields benefits equal to approximately 0.01 percent of GDP. This is equal to about $60 million/year ($3 per person per year) or about 1 days' economic growth. So, if a decision to hold the tariff at 5 per cent avoided adjustment costs to the extent of permitting two days of normal growth in place of two days of zero growth, it would be beneficial. It seems likely that adjustment costs will outweigh any static efficiency benefits. (sub. 63, p. 9)

The Commission agrees that any assessment of the benefits of removing the tariffs under reference needs to be accompanied by consideration of associated adjustment issues and has explored them in detail (see section 3.3 and chapters 4 and 7). This trade-off between beneficial effects of unilateral tariff reductions and adjustment costs was underlined by the NSW Minister for Small Business (sub. 95).

In addition to the work it commissioned, the AIG surveyed 2600 of its members in 11 sectors of manufacturing (including TCF and PMV) in New South Wales (1000 members), Victoria (800 members) and Queensland (800 members) to provide an indication of what the removal of tariffs would mean for them. The sample was selected on the basis of company size as reflected by number of employees. A total of 573 replies were received (22 per cent of members surveyed). The industry affiliation of respondents is given in table 3.1.

As indicated by the table, the AIG survey results are centred on manufacturing industries and are strongly influenced by respondents in the Fabricated metal products, Miscellaneous manufacturing and Machinery and equipment industries, which in total provided 58 per cent of the responses.

Information was provided on AIG members' assessments of the effects of tariff removal on input prices, selling prices, production, sales, employment and investment. Survey responses indicated that:

- declines were expected in all areas by 45–60 per cent of the respondents; increases in all areas by 7–16 per cent; no change by 8–11 per cent and the balance did not know or did not reply;

Table 3.1 **Australian Industry Group survey; industry affiliation of respondents**

per cent

Industry	*Proportion of total*
Food beverages and tobacco	4
Clothing and footwear	4
Paper, printing and publishing	2
Glass, clay and cement products	1
Fabricated metal products	27
Machinery and equipment	14
Construction contractors	3
Textiles	6
Wood, wood products and furniture	3
Chemicals, petroleum and coal products	6
Basic metal products	7
Transport equipment	5
Miscellaneous manufacturing	17
Other (not stated)	1
Total	**100**

Source: Information provided by AIG.

- the inclusion of 84 replies from the TCF and transport equipment industries made little difference to the results;
- expectations of declines in input prices were similar to those of selling prices, averaging 4–5 per cent;
- expectations of changes in production, sales and employment were similar, averaging 12–15 per cent for those who expected declines and 3–4 per cent for those who expected increases;
- for investment, expected declines averaged 23 per cent and expected increases 6 per cent;
- the industries most pessimistic about employment and investment were Basic metal products, Wood, wood products and furniture, and Fabricated metal products; and
- the most optimistic industries were Chemicals, petroleum and coal products, Construction, and Paper, printing and publishing.

While indicative of a range of opinion, the Commission considers that the methodology of, and response rate to, the survey are such that little quantitative significance should be placed on the results. For example, the covering letter with the questionnaire did not mention that manufacturers could benefit from lower input costs if tariffs were removed. It also indicated that the AIG would be strongly resisting any further tariff reductions. This may have influenced the nature of responses. Some of the reported price effects of tariff removal are not credible.

Notwithstanding the potential impact on an individual firm, it is difficult to accept that the removal of the remaining 5 per cent tariffs could have such large aggregate effects on manufacturing as inferred by AIG's presentation of its survey results (sub. D122, p. 12). In the past, more substantial reductions in tariffs were accompanied by an increase in manufacturing output (see chapter 4). Such large aggregate effects are also not supported by the ABL survey (see below). Further, as experience has shown, firms have often adapted far more successfully to cuts in tariffs than expectations expressed when the reductions were contemplated (see box 3.4).

ABL, which represents mainly smaller companies (and in manufacturing, mainly light as opposed to heavy manufacturing), surveyed a random sample of its membership by letter (containing an outline of the inquiry) and follow-up telephone call. The survey covered the broad spectrum of the membership which would be affected one way or other by the removal of tariffs and not just manufacturers. Of the total of 1000 contacted, 359 provided useable responses to their questionnaire. Non-responses were from people with little direct interest in the inquiry, predominantly from the services sector. As with the AIG survey, the Commission considers that the responses are at best indicative rather than conclusive. Overall, ABL said:

> The survey results indicate an increasing preparedness on the part of industry to embrace the changed circumstances brought about by the tariff reduction program. Nonetheless there is a hard core of firms which are finding the increased competition brought about by the tariff reduction program, both challenging and difficult. The industries which appear to suffer the most are drawn from the following industry sectors:
>
> - Chemicals
> - Furniture
> - Steel
> - Fabricated Steel
> - Semi fabricated aluminium
> - Paper
> - Stainless steel (sub. D131, p. 17)

The size distribution and industry affiliations of the respondents are given in table 3.2. As indicated in the table, small businesses were the largest category of business represented, followed by micro and medium-sized businesses.

Among the survey responses were the following results:

- 9 per cent said that removal of the tariffs under reference would make their business more competitive, 82 per cent that it would have no effect, 6 per cent that it would make them less competitive, while 4 per cent did not answer;

Box 3.4 **Tariff cuts and predictions of the demise of manufacturing**

During the post-war period until the 1980s, tariff assistance was used to maintain the viability of many of Australia's manufacturing industries. The prospect of tariff reductions during this period was often met with predictions from these industries that, without protective arrangements, local manufacturing would disappear. Such industry predictions have not proved correct, notwithstanding the demise of some firms and the contraction of some sectors (especially those which are labour-intensive). The Australian whitegoods industry provides an example of a once highly protected manufacturing industry adapting to a more competitive environment, despite initial fears to the contrary.

In 1978, the quotas on whitegoods imports were removed and replaced with a 45 per cent tariff and the industry was reviewed by the IAC. The IAC proposed that tariffs should be reduced to 30 per cent over a period of four years to make the use of resources by the industry more efficient. The industry at the time, to remain viable and while undergoing rationalisation, requested that tariffs remain at 45 per cent for two years followed by 35 per cent for four years and then another review before any further change.

In the event, the tariff on whitegoods was steadily reduced during the 1980s and 1990s. Since 1996, the tariff has been at its current rate of 5 per cent. During this time, there has been a number of changes in the industry through mergers, takeovers and closures, with the number of local producers declining from seven in 1980 to four in the 1990s — Email, Fisher & Paykel, Southcorp and St George. Many of the familiar brand names from earlier times such as Westinghouse, Kelvinator, Frigidaire, Simpson and Hoover remain.

Even after the large decline in tariffs in the past 20 years — from 45 per cent to 5 per cent — the whitegoods industry is not only still in existence, but also has substantially improved its performance in a number of areas.

Turnover increased from around $1 billion in 1980 to more than $2 billion in 1996. Exports as a percentage of turnover increased from 3 per cent in 1980 to nearly 8 per cent in 1996. Local manufacturers continue to maintain a relatively large share of the local market — 63 per cent in 1996 compared with 77 per cent in 1980. The actual market share held by local producers ranges from 75 to 85 per cent, because they import as well as manufacture locally.

Employment in the whitegoods industry declined from around 22 000 in 1980 to around 13 000 in 1996. It has increased in recent years following the establishment of a plant near Brisbane by the new entrant, Fisher & Paykel.

The experience of the Australian whitegoods industry is not unique. Various other previously highly protected manufacturing sectors also continue to exist having successfully adapted to the reduction in tariffs.

Source: IAC (1978), PC (1999b).

Table 3.2 **Australian Business Limited survey; size of firm, industry affiliation, proportion of respondents using imports and proportion with import competition**

per cent

	Proportion of total	*Proportion using imports*	*Proportion with import competition*
Size of firm			
less than 5	24	13	16
5–19	41	22	24
20–99	24	27	36
100 or more	11	24	32
Industry type			
agriculture	2	67	83
mining	2	63	75
textiles	3	67	67
automotive	2	88	75
other manufacturing	16	62	66
construction	5	0	5
retail/wholesale	8	17	21
business, property, finance	10	5	5
other services	44	5	12
don't know	6	4	4
Total	**100**	**21**	**26**

Source: sub. D131.

- of those using imports:
  - two-thirds paid the 5 per cent general rate, one in seven the 3 per cent concessional rate and the balance, one in five, no duty;
  - 45 per cent indicated that imports made up 20 per cent and less of final product cost, 36 per cent that they made up 21–60 per cent of final product cost, and 17 per cent that they made up more than 60 per cent of final product cost;
  - 63 per cent said the tariff created little or no disadvantage, 14 per cent a moderate disadvantage, 9 per cent a substantial disadvantage and the balance, 13 per cent, that it was not applicable or there was no response;
- 71 per cent said they did not know of imported products which compete against their products, whilst 26 per cent said they experienced import competition;
- of those which experienced import competition, 48 per cent said that the competitive imports attracted a tariff, 39 per cent said they did not and the balance did not know or did not respond;

- of those that produced in competition with imports attracting duties:
  - 43 per cent said that the duty was 5 per cent, 11 per cent that it was 3 per cent, 7 per cent that it was 5 per cent and 3 per cent, with the balance, 39 per cent, not knowing which duty applied;
  - 70 per cent said the tariff provided either little or no advantage, 11 per cent that it provided a substantial advantage and 11 per cent that it provided a moderate advantage; and
- the survey also indicated a general lack of awareness of concessional schemes such as the TCS, TEXCO and duty drawback among the members using imports.

In contrast to those producer participants who argued for retention of tariffs, others argued that the tariffs added unnecessarily to their production costs, particularly where there was no local industry to protect (see box 3.5).

In order to gain a better quantitative impression of the scope for removing the tariffs under reference, the Commission modelled the long-run effects of their removal using the MONASH computable general equilibrium model. This was chosen because it can indicate State and regional effects as well as the standard macro-economic and detailed industry results. Full details of the Commission's application of the MONASH model are provided in a separate supplement to this report (available on request from the Commission).

As noted earlier, however, it is likely that even sophisticated modelling techniques of this kind cannot incorporate the more subtle gains in marketplace behaviour which flow from tariff reductions. Nor can econometric modelling provide conclusive forecasts of what will occur in the economy, industries or regions, in a period following tariff reductions. Those outcomes are governed by a much wider range of influences than the tariffs under reference. MONASH has been used solely to illustrate and quantitatively assess the additional effects, as compared with what would otherwise occur, of removing the tariffs under reference. To do this, the model has been run in a dynamic manner by establishing two cases:

- a base case tracing out a year-on-year projected growth path for the economy with no change in tariffs under reference; and
- a policy simulation in which tariffs under reference are removed.

The difference between the two has been used to indicate the effects of removing the tariffs.

Box 3.5 Some arguments for removing general tariffs

Australian Musical Imports:

> We support the removal of the 5% tariff. IMPORTERS DO EMPLOY PEOPLE. Imports do NOT automatically cost jobs. (sub. D97, p. 1)

Printing Industries Association of Australia:

> … a zero tariff regime should be introduced on 1 January 2005 … (sub. 24, p. 6)

Australian APEC Study Centre:

> Australia should reduce its general tariff rate to zero by 2005. This would improve the Australian economy, consolidate the global competitiveness of Australian manufacturing, and restore credibility to the Government's tariff policy. (sub. 48, p. 1)

The Chamber of Minerals and Energy of Western Australia Inc:

> As an efficient and unprotected exporting industry we receive no benefit from tariffs. … tariffs in fact are a drag on the industry as the costs of tariff protection elsewhere in the economy are ultimately borne by our industry and other efficient sectors of the economy. (sub. D109, p. 1)

International Packaging Machinery:

> A Duty Free rate for our machines and parts will allow Australia's food and beverage industries access to the highest technology available on the world market for their packaging needs, at prices that are not inflated by the added 5% impost. As the machines are of high value, savings can be passed on down the line to both local and export markets. (sub. 45, p. 2)

Winemakers Federation of Australia:

> The current import tariff on oak of between 3-5% (depending on the product) is clearly adding substantially to the costs of Australian wine production. There is no competitive reason for such a tariff as there is no Australian oak industry. (sub. 25, p. 2)

WMC Resources:

> Removal of the tariff impost on stainless steel flat products will result in more competitively priced stainless steel products. Such an increase in demand for stainless steel will ultimately be of benefit for nickel producing countries such as Australia. (sub. 42, p. 1)

The Scotch Whisky Association:

> There is no local whisky production in Australia. However, there is a processing, bottling and distribution industry for whisky, which would stand to benefit from tariff elimination … The principal sources of revenue from whisky sales in Australia are the Excise and General Sales Taxes. By contrast, the tariff imposes a significant administrative burden on both the Customs Service and industry without providing any substantial return by way of government revenue … The tariff is not significant enough to have an impact in any future bilateral or multilateral tariff negotiations. (sub. 51, p. 4)

In addition to estimating the effects of removing the tariffs under reference by the standard measure of GDP, the Commission has derived and reported changes in household consumption to indicate more directly the welfare changes involved. The derivation of household consumption takes into account government taxes and welfare payments, tax changes needed to replace tariff revenue and payments to foreigners associated with the financing of the new investment.

In developing its modelling results, the Commission circulated a work-in-progress draft to interested participants and others with a known interest in such quantitative analysis and held a technical workshop on its preliminary results in Canberra on 3 April 2000. The Commission contracted three experts to referee the modelling and present their comments and suggestions for improvements at the technical workshop. A complete copy of the referees' written comments is available on request. The analysis included in this report takes account of those suggestions.

The model

The MONASH model classifies the economy into 113 industries and 115 commodities, of which 66 industries and commodities fall within manufacturing. In modelling the removal of the tariffs under reference, the effects have been traced from individual tariff subheadings to their influence on prices of the 115 commodities included in the model.

The States and Territories are identified separately in the model and the six States are disaggregated further into 55 statistical divisions — giving a total of 57 statistical divisions. As the divisions were chosen to reflect '... identifiable social and economic links between inhabitants and between the economic units within the region, under the unifying influence of one or more major towns or cities' (ABS 1995, p. 18), most contain a substantial mix of primary and ancillary service activities. This means that some of the regional variation from removing the tariffs under reference on smaller, more highly specialised regions is averaged out in the aggregation to larger, more diverse regions.

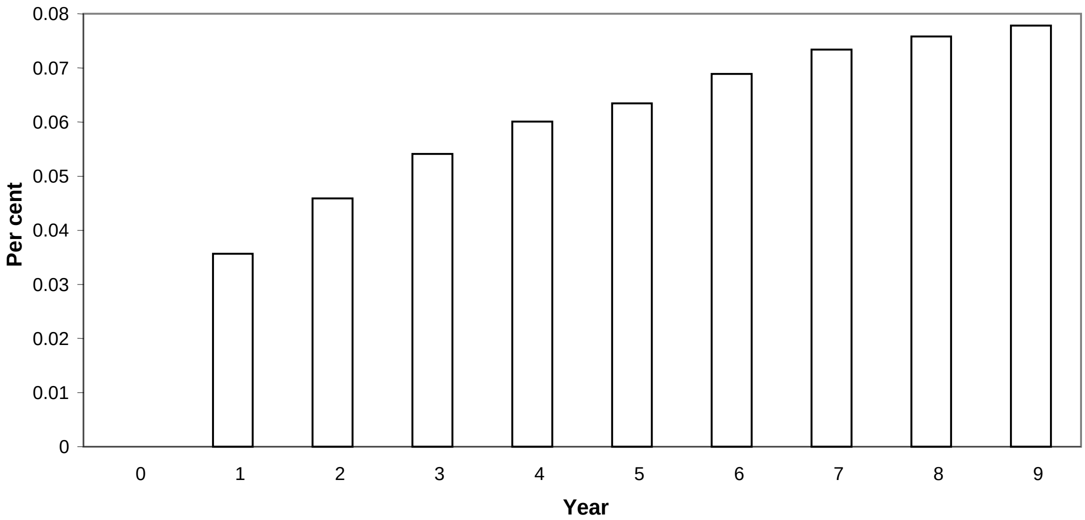
The model adopts a 'tops down' approach to regional analysis. Under this approach, national results are generated for each industry. These results are then subdivided into State effects based on the industry mix of each State's activity, and then further subdivided to give impacts at the statistical division level, again based on the industry mix of each statistical division's activity. Thus, special care is required in interpreting the detailed regional results given below, as such models do not capture with any precision the regional differences between firms within an industry. In part, this reflects the lack of suitable data to incorporate such effects. Nonetheless, the modelling can provide some insights not otherwise available about potential quantitative effects, especially flow-on or indirect effects from the removal of the tariffs under reference.

Economy-wide effects

Removal of the tariffs under reference would provide a permanent small increase in output from the economy over and above what otherwise would occur. As shown in figure 3.1, the increase is estimated to grow from 0.04 per cent of GDP to 0.08 per cent over a nine year period after the tariffs have been removed as producers and consumers adjust to their removal.

Figure 3.1 **Estimated effects on real GDP of removing tariffs on items under reference[a]**

percentage deviations from base case values



a Includes estimated effect of removal of 3 per cent concessional duty.

Source: Commission estimates based on MONASH.

An increase in GDP of 0.08 per cent would be equivalent to around $480 million in 1998-99 prices. This estimated increase is small relative to those estimated at the time to result from the cumulatively larger assistance reductions introduced with the May 1988 Economic Statement (Keating 1988) and the March 1991 Statement (DPM&C 1991). Those increases were estimated at 0.5 per cent of GDP and 0.4 per cent of GDP, respectively (IAC 1988a, appendix 2; IC 1991a). As noted by Professor Garnaut, though, 'close to half a billion per annum of additional output should not be thrown away without good reason' (sub. D164, p. 1).

When account is taken of payments to foreigners associated with financing new investment, terms of trade, tax changes to replace tariff revenue and government provision of services more generally, the estimated permanent increase in household consumption is 0.04 per cent, or around $140 million a year, as shown in table 3.3.

Table 3.3 **Estimated long-run macro-economic effects of removing the 3 per cent concessional duties, the 5 per cent general tariffs and all tariffs under reference**[a]

percentage deviations from base case values

	Concessional duties to Free	*General tariffs to Free*	*All tariffs under reference to Free*
Real GDP	0.01	0.07	0.08
Real household consumption	0.01	0.03	0.04
Real investment	0.10	0.39	0.49
Export volumes	0.04	0.45	0.49
Import volumes	0.10	0.49	0.59
Terms of trade	-0.01	-0.10	-0.11
Pre-tax real wage	0.11	0.49	0.60

a Results reported are estimates for nine years after implementation.

Source: Commission estimates based on MONASH.

The removal of the tariffs under reference (including the 3 per cent concessional duty) is expected to increase imports by an estimated 0.59 per cent a year, and exports by an estimated 0.49 per cent a year. The estimated marginal increase in the current account deficit is associated with the capital inflow to finance the increase in the capital stock of the economy. A slight deterioration in the terms of trade, of 0.11 per cent, is also estimated.

Table 3.3 also shows the effects of removing the 3 per cent revenue duty which has applied since 1996 to concessional imports under the TCS, and project and other policy by-laws. These effects are of the same general direction and of a much smaller magnitude than the total.

The modelling incorporates a link between reduced tariff assistance and manufacturing productivity growth. The effect of this is that the improved productivity growth stemming from removal of the general tariffs is estimated to account for three-quarters of the total 0.08 per cent long-run addition to real GDP.

This ‘endogenous productivity’ link was questioned by the AIG (sub. D122), on the grounds of limited theoretical or empirical evidence in support of it. The AIG pointed out that without this estimated link, there would be no welfare gain (as measured by the permanent change in real household consumption). It should be noted, however, that other elements of the modelling, such as the terms of trade and so-called ‘share’ effects, probably bias downwards the estimated gains in output and consumption.

The inclusion of the endogenous productivity effect in the Commission’s modelling was based partly on the results of relevant research undertaken overseas and in

Australia (Edwards 1993, Frankel and Romer 1999, Chand et al. 1998, Chand 1999, Bloch and McDonald 2000).[4] This research suggests that the static allocative efficiency gains ordinarily associated with tariff reductions are supplemented by wider dynamic gains resulting from a more open and competitive economy.

AIG also considered that this aspect of the modelling could be incorrect because '… it's reasonable to expect that the weakest firms will have a greater propensity to leave and so we'll see a spurious increase in productivity just caused by their selection effects' (DR trans., p. 134). While an exiting firm effect would be present in the industry-level data used in the empirical estimation (as would be an entry firm effect), it is the effect on continuing firms which would be important, given their dominance in industry output. In this regard the recent empirical work of Bloch and McDonald (2000) is instructive. Using panel data for a sample of Australian manufacturing firms over the period 1984 to 1993, their results suggest that '… the movement towards lowering border protection on manufactured imports into Australia has led to enhanced productivity by domestic producers …' (abstract).

Furthermore, inclusion of the productivity link took into account the views of manufacturers themselves. Many have stated that reduced tariff assistance has required them to change their management and work practices, as well as other aspects of their firms' operations (such as research and innovation) in order to match increased competition and remain profitable. For example, when discussing phasing of tariff reductions, the Printing Industries Association of Australia said:

> … [phasing] just tends to delay the initiative in the industry to adopt the best practice, to move with the times, to get technology. You put off the hard decisions until crunch time arrives … [its] better for all concerned, to have crunch time up-front and adjust to it. (trans., p. 166)

Similarly, the PACIA, when summarising the recent development of the chemicals industry, said:

> As recently as fifteen years ago … Tariffs on basic chemical products ranged from zero to 45% while tariffs on other chemical products ranged from zero to 35%. After the 1986 Industries Assistance Commission's Report, the Australian Government made a number of decisions which resulted in chemical tariffs reducing to between zero and 5% by July 1996.
>
> This environment has seen the industry aggressively restructuring, closing inefficient plants, consolidating production and expanding capacity at certain locations to improve scales of production and the financial viability of operations. (sub. 40, p. 1)

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4 The time series study for Australia used by the Commission overcomes many of the methodological problems of the cross country studies identified by Rodriguez and Rodrick (2000).

Special care is required in interpreting the estimated real wage outcome of a pre-tax increase of 0.6 per cent (table 3.3). This is because the results reflect the usual assumption made in such modelling that, in the long run, the benefits of additional economic growth are reflected in improvements in average real wages rather than increases in employment. This is considered an appropriate assumption for long-run analysis as macro-economic factors, such as short-run changes in aggregate demand and the long-run natural rate of unemployment are regarded as the dominant influences on employment. Micro-economic reforms, such as tariff reductions, have their dominant impact on efficiency.

A consequence of this assumption is that the removal of the tariffs under reference leads to a relocation of jobs among industries and regions with no net national change from the employment levels which would otherwise occur. To the extent that, in practice, the additional economic growth contributes to an aggregate long-run increase in employment, the estimated increase in average real wages is likely to be slightly too high.

Sectoral effects

Removal of the tariffs under reference is estimated to result in very minor decreases in output of the manufacturing and agriculture sectors and slight increases in mining and services output (see table 3.4).

In terms of employment, the relocation of labour is estimated to be towards the mining and service sectors from agriculture and manufacturing. The relocation of labour from manufacturing and agriculture reflects not only the minor decline in output in those sectors, but also improvements in labour productivity in manufacturing associated with the removal of tariffs. More generally, higher real wages associated with the removal of tariffs make labour more expensive, favouring a substitution away from it in favour of capital inputs. As a result of these influences, the estimated declines in employment in manufacturing and agriculture are slightly larger than those in output. The estimated changes in sectoral output and employment would generally represent slight deviations from an underlying growth path, rather than actual reductions in output and employment.

For several manufacturing industry groups, the removal of the tariffs under reference, in fact, is estimated to add to the underlying growth in output. These are the Basic metal products, Other machinery and equipment, TCF and Transport equipment groups. For the TCF and PMV industries, the estimated small increase reflects the benefit to them of tariff removal elsewhere in the manufacturing sector — which lowers the price of purchases from other industries and induces additional economic growth and domestic demand — while their assistance remains unchanged. The extent to which such a small increase in output would be realised depends, in part, on the expectations of PMV and TCF producers about their longer-run competitive position, given that their relatively high tariffs are scheduled to be reduced in 2005. Employment is estimated to decline slightly, relative to the base case, in all manufacturing industry groups except Transport equipment and Other machinery and equipment.

Table 3.4 **Estimated long-run sectoral and manufacturing industry effects of removing the tariffs under reference[a]**
percentage deviations from base case values

	Output[b]	*Employment*
	per annum	
Agriculture, etc	..	-0.1
Mining	0.6	0.4
Services	0.2	0.1
Manufacturing:	..	-0.5
- Food, beverages and tobacco	..	-0.2
- Textiles, clothing, footwear and leather	0.1	-0.1
- Wood and paper products	-0.8	-1.6
- Printing, publishing and recorded media	-0.2	-0.6
- Petroleum, coal, chemical and assoc. products	-0.3	-0.7
- Non-metallic products	..	-0.9
- Basic metal products	0.5	-0.1
- Fabricated metal products	-0.2	-1.3
- Transport equipment	0.1	0.1
- Other machinery and equipment	0.6	0.1
- Other manufacturing	-0.7	-1.6

a Results reported are estimates for nine years after implementation. **b** As measured by real industry gross product (ie value added).

.. a decline of less than 0.05 per cent.

Source: Commission estimates based on MONASH.

State and regional results

The estimated long-run effects of removing the tariffs under reference on output and employment have been disaggregated by State and within State by region, using the MONASH model. The results are given in table 3.5.

The higher output at the national level is estimated to flow through to small increases in total output in all States and Territories, and all but four regions (South West in Queensland, and Outer Adelaide, Yorke & Lower North and South East in South Australia). In none of these regions is the estimated decline greater than 0.1 per cent, relative to the base case.

Table 3.5 **Estimated long-run effects of removing the tariffs under reference disaggregated by State and regions**[a]

percentage deviations from base case values

State/*Region*	*Gross regional product*	*Employment*
New South Wales	**0.07**	**0.00**
Sydney	0.05	-0.01
Hunter	0.17	0.08
Illawarra	0.12	0.03
Richmond-Tweed	0.05	0.00
Mid-North Coast	0.04	-0.02
Northern	0.04	-0.01
North Western	0.05	0.00
Central West	0.04	-0.03
South Eastern	0.06	0.02
Murrumbidgee	0.01	-0.05
Murray	0.00	-0.06
Far West	0.10	0.11
Victoria	**0.02**	**-0.05**
Melbourne	0.02	-0.06
Barwon	0.07	-0.01
Western District	0.04	0.00
Central Highlands	0.01	-0.06
Wimmera	0.00	-0.03
Mallee	0.00	-0.03
Loddon	0.01	-0.04
Goulburn	0.02	-0.03
Ovens-Murray	0.01	-0.05
East Gippsland	0.03	-0.06
Gippsland	0.01	-0.06
Queensland	**0.11**	**0.02**
Brisbane	0.07	-0.01
Moreton	0.11	0.04
Wide Bay-Burnett	0.04	-0.05
Darling Downs	0.03	-0.03
South West	-0.01	-0.12
Fitzroy	0.26	0.11
Central West	0.02	-0.06
Mackay	0.26	0.13
Northern	0.14	0.06
Far North	0.11	0.06
North West	0.28	0.34
South Australia	**0.02**	**-0.07**
Adelaide	0.03	-0.06
Outer Adelaide	-0.02	-0.11
Yorke & Lower North	-0.01	-0.08
Murray Lands	0.00	-0.05
South East	-0.11	-0.31
Eyre	0.01	-0.03
Northern	0.12	-0.04

(continued on next page)

Table 3.5 **Estimated long-run effects of removing the tariffs under reference disaggregated by State and regions[a] (continued)**

percentage deviations from base case values

***State**/Region*	*Gross regional product*	*Employment*
Western Australia	**0.21**	**0.10**
Perth	0.18	0.09
Peel	0.17	0.04
South West	0.24	0.08
Great Southern	0.07	-0.01
Wheatbelt	0.15	0.04
Goldfields-Esperance	0.61	0.47
Mid West	0.32	0.24
Gascoyne	0.17	0.13
Pilbara	0.30	0.24
Kimberley	0.19	0.14
Tasmania	**0.07**	**-0.03**
Greater Hobart	0.08	-0.01
Southern	0.02	-0.10
Northern	0.06	-0.05
Mersey-Lyell	0.07	-0.04
Aus. Capital Territory	**0.06**	**0.02**
Northern Territory	**0.22**	**0.13**

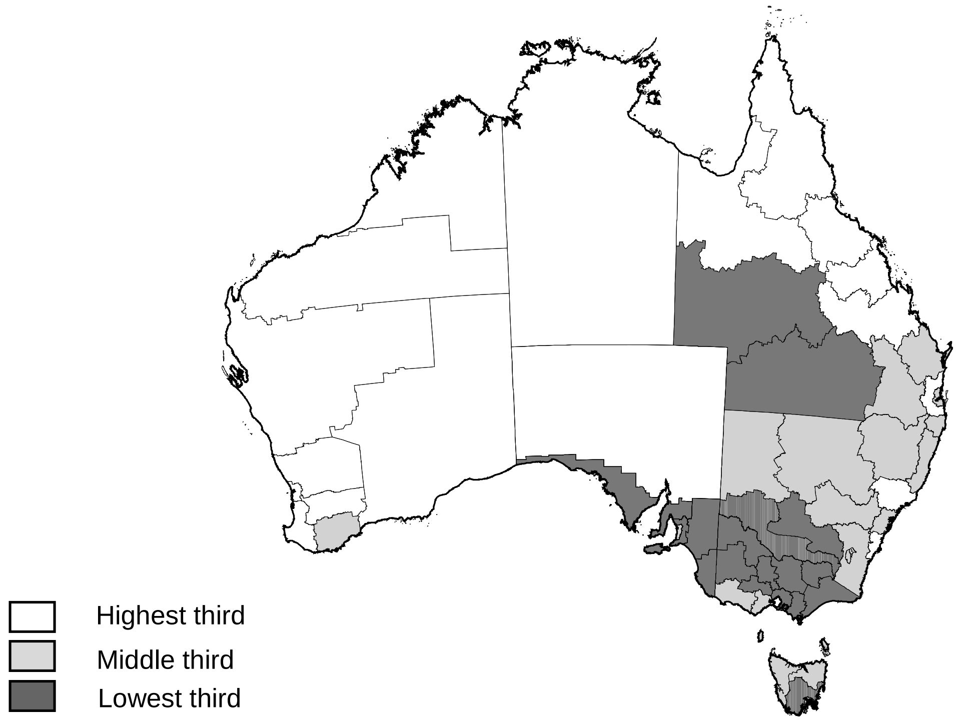
a Results reported are estimates for nine years after implementation.

Source: Commission estimates based on MONASH.

The regions estimated to gain most are those with the greatest dependence on the industries which benefit most from the removal of the tariffs under reference — mining and services. These regions, as indicated in figure 3.2, tend to be located in either inland Australia (mining, and supporting services) or coastal areas (services and light industry).

Many parts of rural and regional Australia are estimated to experience above average output gains as a result of tariff removal. The capital cities (except Perth) are estimated to have average to below average increases in output, reflecting the greater relative importance in those regions of industrial activities supported by the tariffs under reference. Regions relatively dependent on broadacre agriculture, and on high rainfall and water-intensive agricultural activities (such as fruit, vegetables and forestry) are estimated to have the smallest increases in output. For broadacre agriculture, this reflects the influence of higher wages. For the other activities it reflects the adverse effect of the loss of protection by their downstream processing industries, such as fruit and vegetable processing and sawmill products.

Figure 3.2 **Estimated regional output[a] effects of removing the tariffs under reference**



a Output is estimated as gross regional product.

Source: Commission estimates based on MONASH.

The assumed no long-run change in national employment as a result of removal of the tariffs under reference means that the effect of higher labour productivity is a minor relocation of jobs among regions. Employment is estimated to be slightly higher than otherwise in 22 of the 57 regions and slightly lower in 35 regions.

Relative to the base case, there is estimated to be some relocation of labour from Victoria, South Australia and Tasmania to the Northern Territory, Western Australia, Queensland and the ACT. Employment is estimated to be slightly lower in Sydney, Melbourne, Brisbane, Adelaide and Hobart and slightly higher in the other capital cities. While still small, employment outcomes are estimated to vary more among regions in rural and regional Australia than among major urban centres, with some remote regions estimated to benefit most.

3.3 Labour market effects of tariff removal in context

In order to understand the significance of changes in regional employment estimated to result from removal of the tariffs under reference, it is useful to compare them with past changes in regional employment.

ABS data show that there are 12 regions (among the 57 examined) which lost jobs over the decade to the mid-1990s. These are mainly rural and remote regions. The comparison of the estimated effects of removal of the tariffs under reference on employment with changes which occurred over the decade to the mid-1990s provides an indication of the ease or otherwise of adjustment. (The focus is on employment because regionally disaggregated output data are not available for past periods.) In table 3.6, the estimated employment effects on regions of the removal of tariffs relative to recent changes in employment which occurred in those regions are summarised.

Table 3.6 **Estimated relocation of jobs from removal of the tariffs under reference relative to employment changes over the decade to the mid-1990s**

Decade to the mid-1990s		*Estimated employment effect of tariff removal*			
	Total	Gain	Loss: Less than 1yr	Loss: greater than 1yr	**Total**
Lost employment	**12**	3	9	-	**12**
Gained employment	**45**	19	25	1	**45**
Total no of regions	**57**	**22**	**34**	**1**	**57**

Sources: Commission estimates based on MONASH; ABS, *Census of Population and Housing*, Cat. no. 1502.

The estimated employment effects are small — the largest increase, relative to the base case, is only 0.5 per cent (Goldfields-Esperance in Western Australia) and the largest estimated decrease is only 0.3 per cent (South East in South Australia):

- in the 45 regions where employment grew over the decade to the mid-1990s, there would be:
  - more jobs than otherwise in 19 regions; and
  - fewer jobs than otherwise in 26:
    - in all but one of which the estimated loss of jobs would be equivalent to less than one year of the recent growth in jobs; and
    - for that one region (South East in South Australia), it would be equivalent to about two years of the relatively slow growth which occurred in it;

- in the 12 regions which lost jobs over the decade to the mid-1990s, there would be:
  - more jobs than otherwise in 3 regions;
  - fewer jobs than otherwise in 9 regions; and
    - in each, the estimated loss of jobs would be equivalent to less than one year of recent job losses.

Labour adjustment

To assess the adjustment costs associated with the removal of the tariffs under reference, the Commission has used the labour input loss index (LILI) developed by the Monash Centre of Policy Studies (Dixon, Parmenter & Rimmer 1997). Details of the Commission's application of the LILI are given in the modelling supplement to this report.

The LILI measures and estimates the costs of the person years lost because of labour market adjustment. For each year, labour market adjustment costs are calculated for the base case and for the policy simulation case used to indicate the effects of removing the tariffs. The difference between the two paths provides an estimate of the labour market adjustment costs of removing the tariffs under reference.

The estimated labour market adjustment cost for the first full year of implementation of tariff removal is shown in table 3.7. The table also shows separately the effects of removing the 3 per cent revenue duty which has applied since 1996 to concessional imports under the TCS, and project and other policy by-laws, as well as the effect of removing all tariffs under reference. As expected, the magnitude of the labour market adjustment cost resulting from removal of these items is much smaller than that estimated for removal of the 5 per cent tariff.

The estimates are made on the assumption that all the tariffs under reference are removed in a single step. The adjustment costs are estimated to peak at around $90 million in the first full year, declining to around $70 million at the end of the ninth year. The analysis indicates that, even at their peak, the adjustment costs associated with tariff removal would be very small relative to the ongoing adjustment costs in the economy. Also, given the high level of awareness of Australia's APEC commitments, further tariff reductions are likely to have featured in the forward planning of many firms and industries, mitigating the adjustment consequences.

Table 3.7 **Estimated labour market adjustment costs and impact of removing the 3 per cent concessional duties and all tariffs under reference, first full year of implementation[a]**

Component of adjustment	*Person years*	*Dollar values (1998-99 prices)[b]*
	'000	$m
Reference case adjustment	683.0	19 884
Additional net adjustment with removing the 3 per cent concessional duties	0.5	14
Additional net adjustment of removing all tariffs under reference	3.1	91

a The labour market adjustment model used in this analysis indexes labour market changes to mid-year values. The first full-year effect of tariff reductions on labour market adjustment costs is therefore recorded in the second period after implementation. Adjustment costs for that year are reported. **b** The LILI model reports all estimates of labour market adjustment costs as a proportion of the labour force. To convert these estimates to person years and 1998-99 equivalent values, the average number of persons in the labour force in 1998-99 (9.402 million) was adopted as the labour force reference value. It was assumed that average adjustment cost per person year was $29 000, based on average weekly earnings.

Sources: Commission estimates based on MONASH and LILI models; ABS, *Labour Force*, Cat. no. 6202.0; ABS *Average Weekly Earnings*, Cat. no. 6301.0).

A number of participants commented on the choice, in the draft report, of average weekly earnings as a basis for the average adjustment cost per person and considered that the average weekly earnings in manufacturing of around $36 000, or a higher wage cost, would be more appropriate (AIG sub. D122, PACIA sub. D123, Penrice Pty Ltd sub. D129, SA Government sub. D150). The Commission agrees that the choice of cost basis for indicating labour adjustment costs is important. However, any adjustment is not confined to firms directly and adversely affected. The estimated costs include transitional costs incurred by people moving in order to take up opportunities to improve their earnings, as well as costs incurred by those displaced from work. Nor is it confined to a relocation of jobs within the manufacturing sector — although that is where the main adverse effects would be most apparent. The adjustment would involve a relocation of jobs more generally in the community among a range of occupations which have a wide range of average wage levels.

A re-examination of the job relocations among occupations indicated by the computations for the LILI and of the wage rates involved indicates that average weekly earnings remains appropriate given the totality of relocations involved, both within the manufacturing sector and elsewhere, and that the choice of the manufacturing sector average would clearly overstate the labour market adjustment cost. For practical purposes, the estimated labour market adjustment cost can be considered as being proportional to the average wage rate chosen. Even if the average weekly earnings in manufacturing were used, the estimates indicate that the ongoing benefits exceed the initial peak labour adjustment costs.

4 Some issues related to tariff reform

Following on from chapter 3, which presented the broad efficiency and welfare arguments for further reductions in general tariffs, a number of issues which may strengthen or weaken the scope for tariff reductions are discussed in this and the following two chapters. Those relating to trade policy are drawn together in chapter 5, with issues relating to tariff concessions discussed in chapter 6. First, however, this chapter considers issues relating to:

- the impact of microeconomic reform and structural adjustment on Australian industry;
- the schedule for PMV and TCF tariff reform; and
- the scope for 'fine tuning' by reducing tariffs only where there is no significant Australian production — so called 'nuisance tariffs'.

4.1 Microeconomic reform and structural adjustment

The terms of reference specify that, in proposing and discussing options, the Commission take into account the impact on Australian industry of microeconomic reform and the pace of structural adjustment. This raises two issues: whether microeconomic reform generally is likely to ease the adjustment process associated with tariff change; and whether the pace of structural adjustment — in response to microeconomic reform and to a myriad of other social, environmental and economic changes — is already so rapid that further tariff reductions would be unwise at this time.

The Commission's first annual report examined the issues of microeconomic reform, adjustment to change and improvements in living standards (box 4.1). The report argued that higher productivity and growth are essential to support higher wages and improve job prospects. They are also the only sustainable basis for community expenditures on health and education and the maintenance of fair and effective social support mechanisms, including for those most vulnerable to change (PC 1998a).

Box 4.1 **Aspects of microeconomic reform**

Background

Milestones in microeconomic reform date back many years. Key reforms include the removal of import licensing in 1960, the 25 per cent tariff cut in 1973 and the floating of the Australian dollar and financial market liberalisation in the early 1980s. However, it has only been since the mid-1980s that microeconomic reform has gathered momentum and become more widespread.

Microeconomic reforms have covered a broad range of areas including capital markets, industry protection, government business enterprises, labour markets, business and corporate regulation, competition policy, and taxation. Some key reforms include:

- removal of quotas on imports;
- phased reductions in tariffs;
- labour market reforms, including provision for collective and individual agreements at the workplace level;
- diverse government business enterprise reforms including pricing reforms, separate funding of community service obligations, establishing accounting standards, the setting of performance targets, the instituting of competitive neutrality conditions and privatisation; and
- financial incentives and market-based instruments to improve environmental management.

Productivity and microeconomic reform

In the 1990s, there has been a marked improvement in Australia’s rate of productivity growth. Multifactor productivity grew by 1.7 per cent a year from 1993-94 to 1998-99, compared with an average of 0.9 per cent a year between 1964-65 and 1993-94.

Assessment of the linkages between gains in productivity and microeconomic reform is complicated because other factors can also influence productivity growth. However, the timing of gains in productivity is consistent with a response to the introduction of reforms. The stronger productivity performance of the early 1990s may reflect continuing adjustment in response to earlier reforms (such as trade and financial market liberalisation) and a response to more recent reforms (such as national competition policy and industrial relations).

Source: PC (1999b and 1999d).

The report noted that, although accurate measurement is not possible, a range of indicators point to substantial benefits from reform so far. For example, national productivity has shown an upturn during the 1990s, there have been gains in a number of industries and lasting incentives for improved performance. It was noted that, while much has been achieved, the reform process is far from comprehensive or complete and a number of agreed reforms are yet to be fully implemented (PC 1998a).

Broad-ranging reform can reduce the costs of adjusting to particular policy changes. This is because groups adversely affected by a particular reform are more likely to receive offsetting benefits where reforms are implemented on a broad front. For example, a study of the combined distributional effects of tariff, electricity, telecommunications and public sector reform estimated that, although tariff reform reduced manufacturing employment by 0.3 per cent, the net effect of all four reforms was to increase employment in that sector by about 1.2 per cent (PC 1998a).

Two participants in the current inquiry have also argued that microeconomic reform increases the gains from tariff reduction while easing adjustment. ACCI commented that it:

> does not take the view that further tariff reform should be contingent on further progress in other areas of microeconomic reform. Rather, we would emphasise that the wider reform agenda is far more important to the Australian economy. Further, the gains from tariff reform will be less, and the damage inflicted on the losers will be greater, if tariff reform is not undertaken in an environment of broader microeconomic reform. (sub. 44, p. 5)

Similarly, DFAT submitted that:

> The areas subject to most of the non-tariff reforms have been in non-traded areas of the economy — predominantly in service industries such as utility services, telecommunications and transport. By reducing costs for a wide range of other industries in the traded sector, these reforms have made adjustments to past tariff liberalisation much easier. For example, lower prices for utility services and transport has assisted a broad range of import competing industries for which they are significant inputs. Similarly, further, ongoing microeconomic reform is likely to ease adjustment to future tariff reform, including reform to general tariffs. (sub. 65, p. 20)

In the Commission's view, general microeconomic reform facilitates the adjustment consequent on tariff reductions. In other words, broad ongoing microeconomic reform supports the case for tariff reform, rather than being an argument against it.

As well as microeconomic reform, including the overall decrease in tariff assistance which has been taking place since the early 1970s (see section 2.5), a wide range of social and economic factors contribute to economic growth and change generally, including change in the structure of industry and in the regional location of activity. These factors include population trends, technological change, productivity growth, shifts in the pattern of consumer demand, together with changes in a whole range of government policies including substantial reductions in tariffs on imports.

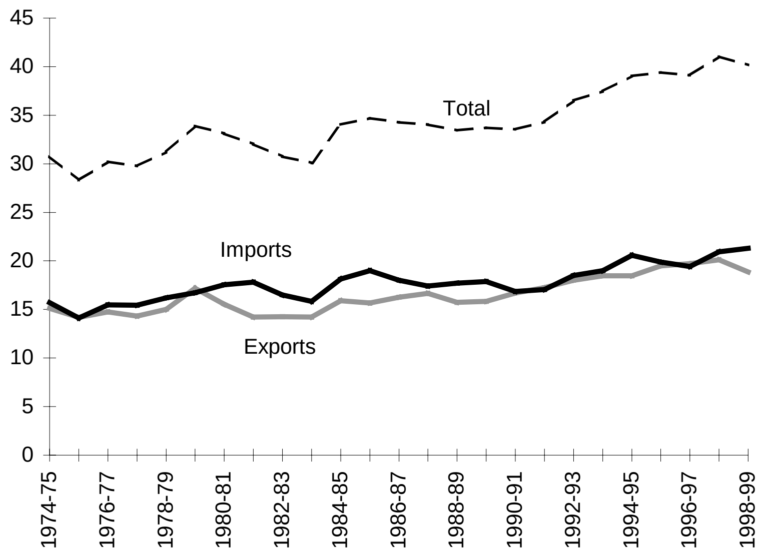
Indicators of continuous structural change

In association with overall growth in economic activity, there has been considerable structural change in Australia since the 1970s, including increased levels of trade, large shifts in the pattern of output and employment among industries and regions and changes in the labour market.

Increased trade intensity

Progressive trade liberalisation and a decline in the real exchange rate have played a significant role in the growing importance of trade over the last two decades. Trade intensity (exports plus imports of goods and services, as a proportion of GDP) has increased from 31 per cent in 1974-75 to 40 per cent in 1998-99 (figure 4.1). The growth in total exports over this period was very similar to that in total imports.

Figure 4.1 **Trade intensity, 1974-75 to 1998-99**
per cent of GDP



Source: EconData (2000) (ABS tables 5206-51 and 5206-47).

Furthermore, during the period in which the substantial reduction in tariffs has occurred, Australia's current account deficit changed little. It represented 5.5 per cent of GDP in 1998-99 compared with 5.3 per cent in 1988-89. The nation's capacity to service its external debt has increased noticeably: net debt as a proportion of exports declined from 17 per cent in 1988-89 to 9 per cent in 1998-99 (Commonwealth Treasury 1990, 1999).

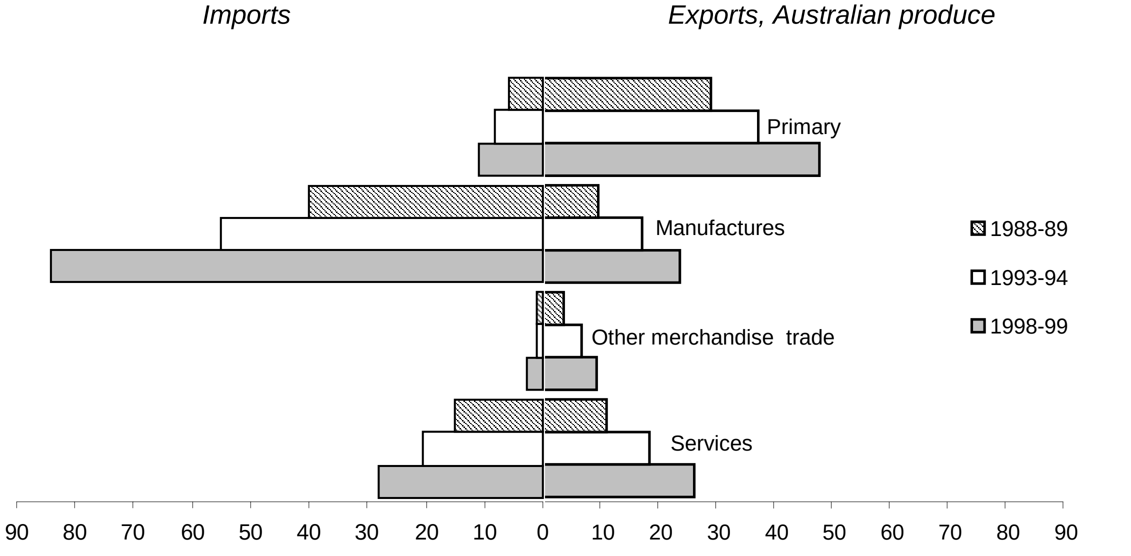
This is not surprising. While tariff reductions lead to additional imports, they also improve the efficiency of the economy. Because tariff reductions decrease exporters' costs of production, they also help to stimulate exports. These effects, together with the operation of a flexible exchange rate and improved macro-economic policy, mean that concern about significant effects on the external payments position as a result of tariff reductions is misplaced.

Australia's traditional exports of minerals, fuels and agricultural products continue to form the majority share of Australia's exports of goods and services. However, their share of total exports has fallen as a result of accelerated growth in exports of manufactured products and services.

- In 1988-89, exports of primary products were valued at $29 billion, equivalent to 54 per cent of total exports of goods and services. In 1998-99, primary product exports were 64 per cent higher, but their share of total exports had declined to 45 per cent.
- Over the same period exports of manufactures grew from 18 per cent to 22 per cent of total exports of goods and services.
- And the services sector's share of total exports increased from 21 per cent to 24 per cent (figure 4.2).

Figure 4.2 **Australian external trade by sector: 1988-89, 1993-94 and 1998-99**

$ billion



Source: Merchandise trade DFAT (2000a), services Econdata (2000) (ABS table 5368-05).

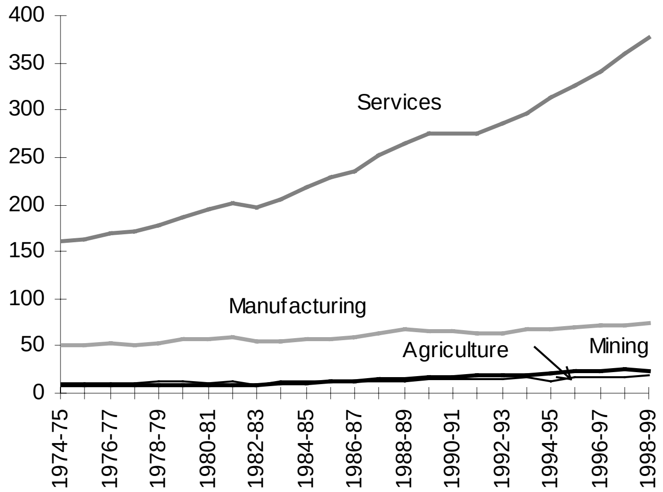
Manufactured goods continue to account for the bulk of Australia's imports. Between 1988-89 and 1998-99 imports of manufactures more than doubled to reach $84 billion, equivalent to 67 per cent of total imports. In 1988-89, manufactures represented 63 per cent of total imports. Imports in the primary, services and other sectors also increased over the same period (figure 4.2).

Sectoral changes in output

There has been considerable growth in national output in recent decades. Since 1974-75 GDP (in real terms) has more than doubled, increasing from $271 billion to $592 billion in 1998-99. This growth has been driven primarily by the services sector. Between 1974-75 and 1998-99 output of services increased by 130 per cent and the sector's share of total output increased from 70 per cent to 76 per cent (figure 4.3).

Figure 4.3 **Output (gross value added), 1974-75 to 1998-99**

$ billion 1997-98



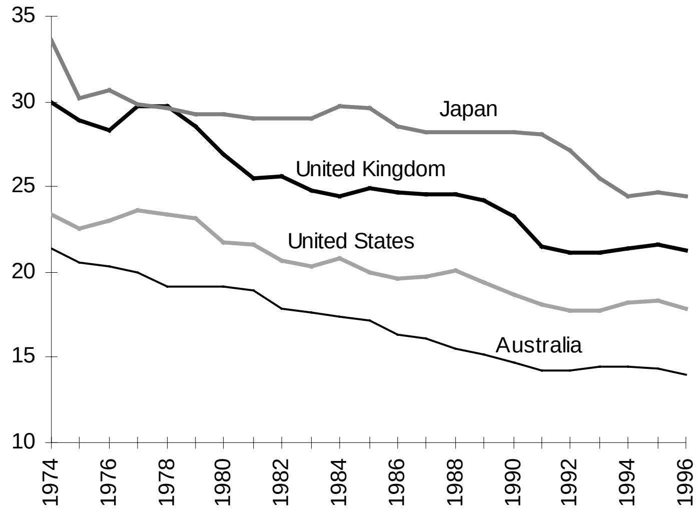
Source: EconData (2000) (ABS table 5206-48).

The mining sector has also recorded higher levels of output over this period; and its share of total output has increased from 3.8 per cent in 1974-75 to 4.9 per cent in 1998-99. Similarly, agricultural output was higher in 1998-99 than in 1974-75 (figure 4.3). However, the sector's share of output has fallen slightly — from 4.4 per cent in 1974-75 to 3.9 per cent in 1998-99.

Like agriculture, output growth has been slower in the manufacturing sector than in the rest of the economy (figure 4.3). As a result, the sector's share of national production has fallen considerably — from 22 per cent in 1974-75 to 15 per cent in 1998-99. This trend has been evident amongst most developed economies and many developing economies. Rising incomes and technological change have resulted in increased demand for services. Manufacturing's share of output has declined significantly, for example, in the United States, Great Britain, and Japan (figure 4.4).

Figure 4.4 **Manufacturing's contribution to GDP, selected countries: 1974 to 1996**

per cent



Source: EconData (2000).

Changes in the labour market

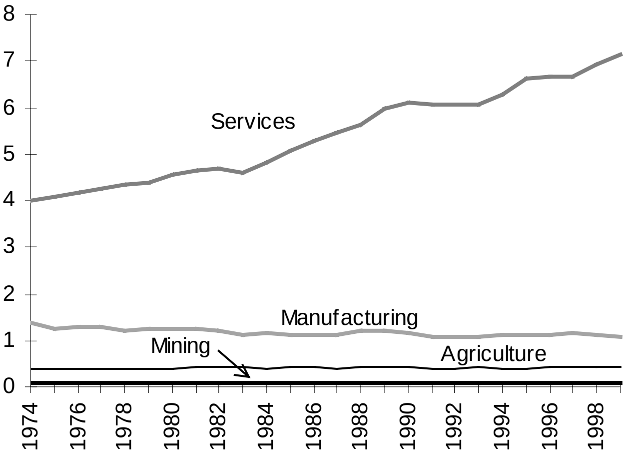
Employment growth has been significant in recent decades — since 1974, in net terms, almost 3 million jobs have been created. A feature of this increase has been the growth of part-time employment.

- Between 1974 and 1999, the number of people employed in part-time jobs increased from 0.7 million to 2.2 million.
- The number of full-time jobs grew by a similar absolute amount, but this was equivalent to an increase of about one-quarter of full-time positions.
- As a result, the proportion of people in part-time jobs increased from about 12 per cent of total employment in 1974 to 26 per cent in 1999.

Rapid growth in part-time employment can be explained in part by increased participation in the labour force by women, particularly married women. In 1974, the female participation rate was 42 per cent; by 1999, it had increased to 53 per cent (PC 1998b and ABS 1999b).

Like output growth, employment growth has been driven by the services sector. Between 1974-75 and 1998-99 employment in the services sector more than doubled and the sector's share of total employment increased from 68 per cent to more than 80 per cent (figure 4.5).

Figure 4.5 **Employment, 1974-75 to 1998-99**
million



Source: PC (1998b) and ABS (1999b, August values).

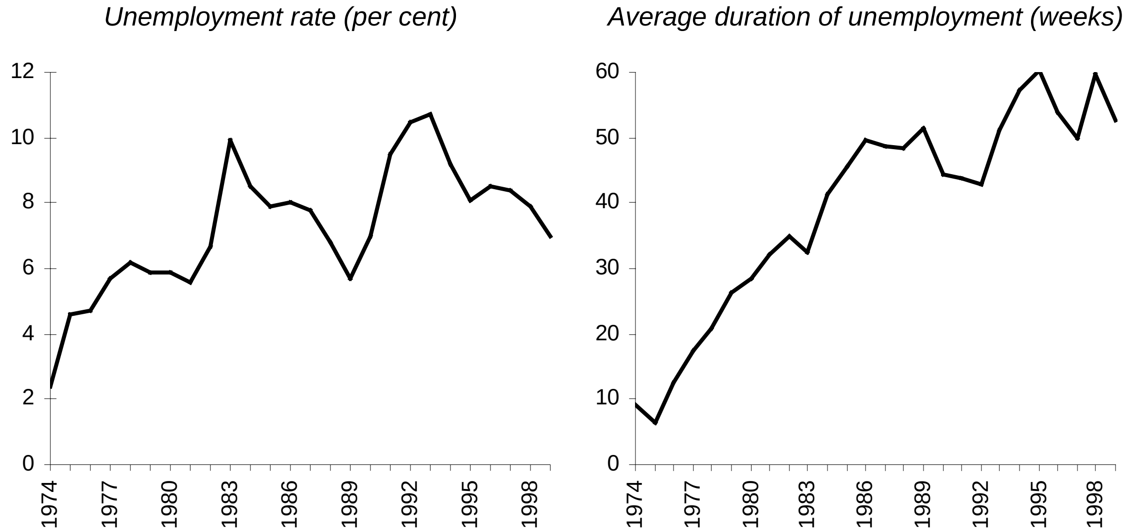
The agriculture and mining sectors also recorded higher levels of employment over the last two decades. However, their growth rates have been significantly lower than that in the services sector (figure 4.5).

In the manufacturing sector, employment fell by 300 000 or 22 per cent between 1974 and 1999 (figure 4.5). As a result, the sector's share of employment has fallen considerably — from 24 per cent in 1974 to 15 per cent as at June 2000. However, as discussed later, some of this decline can be accounted for by increased specialisation and a transfer of labour from the manufacturing to the services sector, within a growing total labour market.

Despite the overall growth of the Australian economy, one of the most noticeable changes in the labour market over the last two decades has been the substantial increase in unemployment and in the duration of unemployment (figure 4.6).

- The August unemployment rate increased from 2.4 per cent in 1974 to 10.5 per cent in 1992 before falling back to below 7 per cent at present.
- The average duration of unemployment has risen from an average of 9 weeks in 1974 to about a year in 1999.

Figure 4.6 **Unemployment and the average duration of unemployment, 1974 to 1999**



Source: PC (1998b, pp. 46-47) and ABS (1999b, August values).

The mobility of Australia's workforce has a bearing on the capacity of the community to adjust to changes in the structure of production and employment. If mobility is low, adjustment may be difficult; if it is high, the problems of adjustment to change are reduced. There are two types of labour mobility — the movement of people between industries and occupations and the movement of people between regions. The latest ABS data on labour mobility indicate a highly mobile Australian workforce.

- Of the people who worked during the year ending February 1998, 14 per cent or 1.3 million (voluntarily and involuntarily) changed their employer and/or their location of work**.** Of these, 40 per cent changed their industry and 34 per cent changed occupation (ABS 1998a).
- Between 1991 and 1996, nearly 800 000 people relocated to another State. New South Wales had the largest number of total departures (243 000) and Queensland the largest number of total arrivals (268 000) — mobility of people between States was at a similar level between 1986 and 1991, when 780 000 people in total relocated to another State (PC 1998b).

During the past 20 years, job losses due to retrenchment or business closures have typically accounted for only 15 to 20 per cent of total job separations (PC 1998a). Further, ABS (1998b) survey data on retrenched workers found that:

- in the three years to July 1997, more than 685 000 people or 7 per cent of those employed were retrenched;

- the major reasons stated for retrenchment were insufficient work or job cuts (46 per cent), business closure (15 per cent) and a change of management (8 per cent);
- the industries accounting for the largest number of retrenched workers were manufacturing (24 per cent), retail trade (12 per cent) and construction (9 per cent). Industries which recorded the highest proportions of retrenchments relative to the number of employees in the industry at May 1997 were electricity, gas and water (28 per cent), manufacturing (15 per cent) and mining (13 per cent) (ABS 1997 and 1998b); and
- by July 1997, 55 per cent of workers who were retrenched in the preceding three years had found new jobs. Of these, 77 per cent did not change their full-time or part-time status, 16 per cent changed from full-time to part-time employment and the remaining 8 per cent changed from part-time to full-time employment.

Notwithstanding this level of retrenchments, in the three years to August 1997, total employment increased by about 430 000, or 5 per cent. Even within the manufacturing sector, total employment rose by 25 000, or 2 per cent.

Structural change in regions

The impact of structural change on Australia's regions has varied considerably (PC 1999a). Table 4.1 shows large differences in employment growth rates among regions, with a number contracting while others expanded.

Table 4.1 Employment change: largest regional increases and decreases, 1981 to 1996

Top 10 regions	*Employment increase*	*Bottom 10 regions*	*Employment decrease*
	%		%
North-West (NT)	168.0	Lyell (Tas)	-58.2
Dale (WA)	127.7	Far West (NSW)	-31.1
Gold Coast (Qld)	125.6	North Wimmera (Vic)	-30.9
Sunshine Coast (Qld)	112.2	Whyalla (SA)	-28.1
Vasse (WA)	111.1	West Central Highlands (Vic)	-27.5
Cairns City (Qld)	98.3	Flinders Ranges/Pirie (SA)	-21.8
Queanbeyan (NSW)	97.6	Hotham/lakes (WA)	-18.8
Fitzroy (WA)	80.8	North Eastern (Tas)	-17.1
Moreton Balance (Qld)	74.7	Pallinup (WA)	-15.5
Lefroy (WA)	70.1	Macquarie-Barwon (NSW)	-11.8

Source: PC (1998b, p. 115).

Growth and adjustment in the manufacturing sector

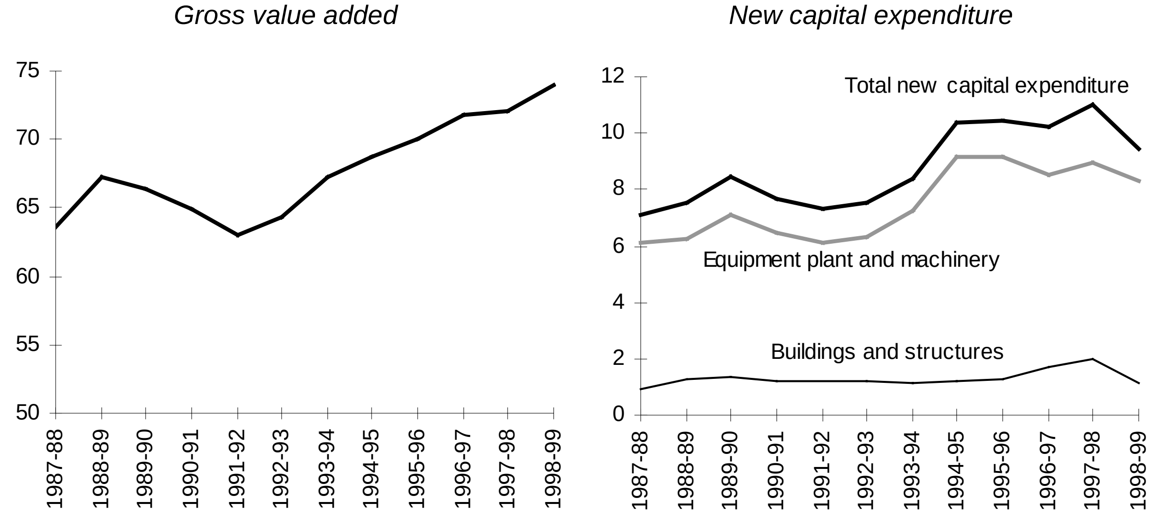
The manufacturing sector has undergone significant change in recent decades. Trends in output, investment, employment and trade provide a basis for assessing how the sector has adjusted to a range of factors, of which tariff reductions have been only one.

Output, productivity and investment

Over the last decade, manufacturing output, productivity and investment have continued to increase, notwithstanding the reductions in tariff assistance provided to it. Between 1987-88 and 1998-99 for example:

- manufacturing output increased by 16 per cent;
- multifactor productivity grew on average by 1.1 per cent a year; and
- investment increased more than 30 per cent or an average of 4 per cent annually (figure 4.7).

Figure 4.7 **Manufacturing output and investment, 1987-88 to 1998-99**
$ billions



Source: Gross value added EconData (2000) (ABS table 5206-48); new capital expenditure Econdata (2000) (ABS table 5625.0).

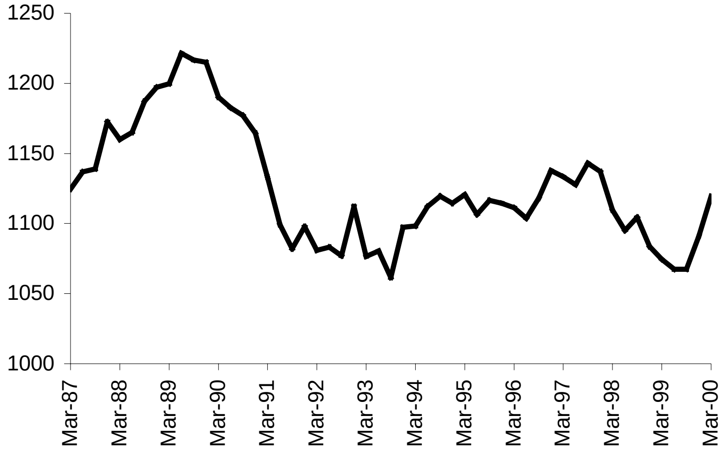
Employment

In contrast, over the same period manufacturing employment has declined.

- During the late 1980s and the recession in the early 1990s, manufacturing employment declined significantly.

- Since then, it has largely stabilised at around 1.1 million, with increases being recorded in the last three reported quarters (figure 4.8).

Figure 4.8 **Manufacturing employment, March 1987 to March 2000**
number employed (quarterly), ('000)



Source: Econdata (2000) (ABS table 6203.0).

The employment statistics need to be treated with caution. Some of the decline in manufacturing employment, as measured, reflects contracting-out of some activities to service sector businesses. There has been increased specialisation of economic activity, especially during the 1990s, as competition has increased. Businesses in the private and public sectors have made greater use of specialised service providers rather than using their own staff to perform functions such as transport, accounting, cleaning etc. An important effect of this change of approach has been to change the sectoral location of production and employment towards service industries. In other words, the measured change in manufacturing employment overstates the actual decline in manufacturing jobs. While manufacturing employment was lower in 1999 than in 1987, over this period the total number of people employed in the economy increased by 1.7 million, or 23 per cent, to a total of 8.7 million (table 4.2).

While service sector jobs have accounted for most of Australia's employment growth in recent years, it is sometimes thought that these jobs are not as valuable as manufacturing jobs and are mainly unskilled and low paid. However, service jobs are not typically lower paid or unskilled. Of all 14 service industries, nine industries, in March 2000, recorded higher average weekly earnings for full-time adults than manufacturing and five service industries recorded higher earnings for all employees than manufacturing (Econdata 2000; ABS table 6302.0). The service sector accounted for 78 per cent of full-time employment in Australia, very similar to its share of total employment.

Within manufacturing, there have been marked differences among industry groups in the provision of jobs. A number of manufacturing industries such as food, beverages and tobacco, printing, publishing and recorded media as well as petroleum, coal chemicals and associated products and ‘other’ manufacturing have recorded employment growth since 1987 (table 4.2). However, within these broad categories the performance of certain industries relative to the manufacturing sector as a whole has been mixed. For example, employment in the chemical industry has declined during the 1990s. Even in that industry, however, output has increased (albeit at a lower rate than for manufacturing as a whole), as have exports. Huntsman Corporation Australia, a manufacturer of surface active agents and chemicals derived from ethylene oxide, has increased its exports by 50 per cent over the last two years (sub. D130).

Industries which have the highest, though much reduced, assistance levels (TCF and machinery and equipment) have recorded the largest proportional reductions in employment in recent years (table 4.2). Indeed, if these two sectors are excluded from the manufacturing average, employment for the remainder of the manufacturing sector, that is, for the industries which are the focus of this report, was marginally higher in 1999 than 1987.

Table 4.2 **Employment changes by sector, 1987 to 1999**

	Employment		*Change in employment*	*Average annual change in employment*[a]
	1987	1999	1987 to 1999	1987 to 1999
	’000	’000	%	%
Agriculture	**404.1**	**435.7**	**7.8**	**0.2**
Mining	**98.5**	**75.6**	**-23.2**	**-1.9**
Manufacturing	**1139.0**	**1067.5**	**-6.3**	**-0.6**
Food, beverages and tobacco	179.6	178.3	-0.7	0.6
Textiles, clothing and footwear	124.9	76.3	-38.9	-2.9
Wood and paper products	74.4	63.9	-14.1	-1.6
Printing publishing and recorded media	104.9	114.7	9.3	0.8
Petroleum, coal, chemicals and associated products	92.4	108.0	16.9	0.2
Non-metallic mineral products	48.4	48.0	-0.8	-0.3
Metal products	185.9	169.9	-8.6	-0.8
Machinery and equipment	257.8	223.4	-13.3	-1.4
Other manufacturing	70.8	85.0	20.1	0.9
Manufacturing less TCF and machinery and equipment	**756.3**	**767.8**	**1.5**	**0.0**
Services	**5450.5**	**7152.9**	**31.2**	**2.0**
Total	**7092.2**	**8731.6**	**23.1**	**1.5**

[a] calculated by fitting an exponential curve to the annual data.

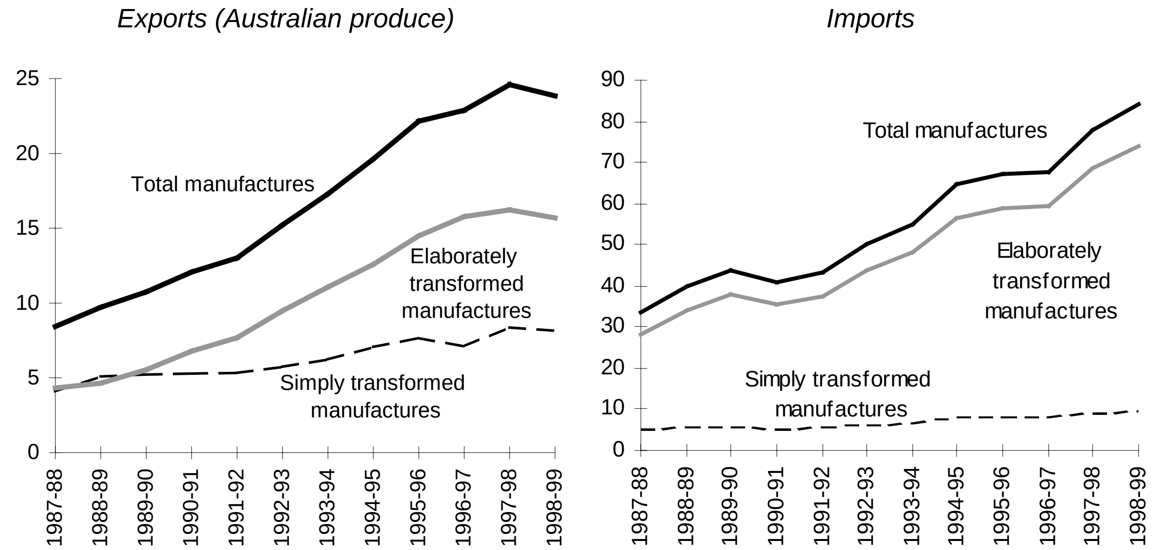
Source: PC (1998b) and ABS (1999b, August values).

Manufacturers have become more trade-oriented over the last few decades.

- Exports of manufactures increased by more than 180 per cent between 1987-88 and 1998-99, or an average of 11 per cent each year.
- Imports of manufactures increased by 150 per cent between 1987-88 and 1998-99, or an annual average of 8 per cent (figure 4.9).

Figure 4.9 **Exports and imports of Australian manufactures, by sector[a], 1987-88 to 1998-99**

$ billion



a DFAT's Trade Exports Classification system defines manufactures as simply transformed (STMs) or elaborately transformed (ETMs) manufactures. ETMs are defined as products with unique features which permit identification as differentiated products on world markets, ie. finished goods. STMs comprise basic-manufactured and semi-manufactured-products.

Source: DFAT (2000a).

Elaborately transformed manufactures (ETMs) have been the fastest growing component of manufacturing trade in recent decades. For example, exports of ETMs increased by more than 230 per cent between 1988-89 and 1998-99, or an average of 14 per cent per year**.** Within ETMs, the largest growth areas have been office and telecommunications equipment and road motor vehicles and parts**.** Growth in exports of simply transformed manufactures (STMs) has also been significant. Between 1988-89 and 1998-99 exports of STMs increased by 60 per cent, or an average of 6 per cent per year (table 4.3)**.** Even industries which have experienced weak growth in output have increased their exports and imports relative to turnover.

Table 4.3 **Exports of Australian manufactures by industry, 1988-89 to 1998-99**

	Exports		*Change in exports*	*Average annual change[a] in exports*
	1988-89	1998-89	1988-89 to 1998-99	1988-89 to 1998-99
	$m	$m	%	%
Elaborately transformed manufactures	**4 640**	**15 688**	**238**	**14**
Non-metallic mineral manufactures	47	158	240	12
Iron & steel	387	916	136	10
Non-ferrous metals	298	722	143	13
Chemicals & chemical preparations	609	2 236	267	15
Other semi-manufactures	106	372	250	15
Specialised machinery	555	2 097	278	15
Office & telecommunications equipment	250	1 217	387	19
Road motor vehicles & parts	337	1 896	463	16
Other machinery & transport	1 161	3 599	210	14
Household equipment	273	534	96	10
Textile fabrics	127	439	245	15
Clothing & footwear	69	317	359	16
Miscellaneous manufactures	421	1 183	181	11
Simply transformed manufactures	**5 086**	**8 160**	**60**	**6**
Basic non-metallic mineral manufactures	46	17	-63	-11
Basic iron & steel	44	127	192	17
Basic non-ferrous metals	3 867	4 668	21	2
Non-metallic mineral manufactures nes	222	526	137	9
Iron & steel unworked nes	81	586	623	14
Chemicals & chemical preparations	368	975	165	11
Other semi-manufactures	226	777	244	14
Other manufactures	231	484	109	14
Total manufactures	**9 726**	**23 848**	**145**	**11**

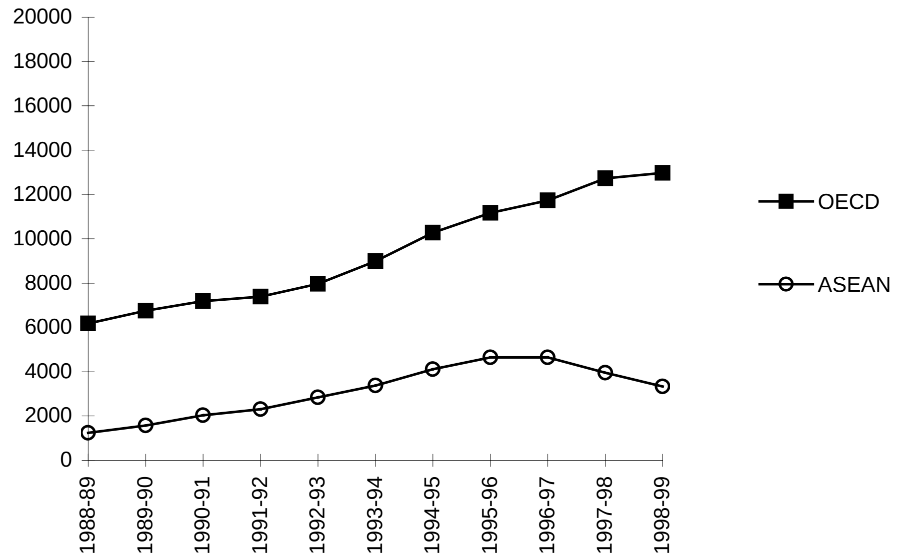
[a] calculated by fitting an exponential curve to the annual data.

Source: DFAT (2000a).

In 1998-89, growth in manufacturing exports fell as a result of the Asian crisis (figure 4.10). However, the ability of the sector to compensate for this downturn by increasing exports to the OECD countries is a positive indicator of the sector's ability to adjust to change (figure 4.10). Growth in trade by region is discussed further in chapter 5.

Figure 4.10 **Exports of Australian manufactures by major country group, 1988 to 1999**

$ million



Source: DFAT (2000a).

Summary

The picture painted by indicators on the performance of manufacturing over the period 1987-88 to 1998-99 is mixed. On the one hand, growth in manufacturing output has been slower than in the rest of the economy, continuing the pattern in earlier periods, and measured employment has shown little net change. On the other hand, there are a number of indicators which suggest that manufacturing has successfully adjusted to changes such as trade liberalisation. For example:

- there has been significant growth in investment in recent decades;
- increased specialisation (which has resulted in a shift in resources away from the manufacturing to the services sector), together with the increased trade-orientation of manufacturers, has coincided with gains in efficiency and productivity;
- the pattern of manufacturing output has changed, with labour intensive industries declining and others expanding;
- an acceleration in the growth of exports of ETMs signals the increasing competitiveness of the manufacturing sector and reduced reliance on Australia's exports of primary products; and
- the ability of manufacturers to find new export markets during the Asian crisis is a further sign of competitiveness and adaptability.

More broadly, this review of growth and structural change shows that large changes are occurring all the time. Similar shifts in the structure of activity and employment are also evident in most developed countries. To a large extent, structural change is autonomous, occurring independently of change in government policy in general and microeconomic reform in particular. For some people, changing jobs can be difficult and result in reduced income and/or loss of employment. However, the available data suggests that voluntary movement by people to other jobs in response to changes in the pattern of economic activity is widespread.

In general, attempts to slow down or to stop structural change would be costly and counterproductive. Indeed, structural change — whether autonomous or in response to microeconomic reform — fosters economic growth and the related ability of the community to support its less fortunate members through the generally available ‘safety net’ arrangements and other measures.

Microeconomic reform and continual structural change should not be seen as impediments to further tariff reductions — small adjustments are easier to make in an environment of ongoing growth and structural change than in a static environment.

Nevertheless, the possible adjustment consequences from further tariff changes for particular industries and regions are explored in more detail in section 7.2.

4.2 Schedule for PMV and TCF tariff reform

The PMV and TCF sectors are excluded from the inquiry. However, the terms of reference require the Commission, in considering options, to take into account the schedule for tariff reform in those industries.

Background

Under the general programs of phased tariff reductions that were introduced in May 1988 and March 1991, most tariff rates were reduced to 5 per cent or less by July 1996. In fact, with the exception of 5 tariff sub-headings relating to cheese, the only remaining general tariffs of more than 5 per cent relate to the PMV and TCF sectors.

Nevertheless, the level of tariff assistance afforded to the PMV and TCF sectors has also declined significantly during the 1990s (table 4.4). The Government has announced that there will be no tariff reductions for those sectors between 2000 and 2004. Legislation has been passed to reduce tariffs further on 1 January 2005.

Table 4.4 **Selected PMV and TCF tariff rates**

per cent

	1990	*1996*	*2000*[a]	*2005*
Passenger motor vehicles	40	25	15	10
Apparel and certain finished textiles	55	37	25	17.5
Footwear	45	27	15	10
Woven fabrics	40	25	15	10
Sleeping bags, table linen	25	15	10	7.5
Other TCF (eg. yarns and leather)	15	5	5	5
General manufacturing	15	5	5	Under review

a TCF rates were effective from 1 July.

Source: IC (1997) and information provided by DISR.

- Tariffs on passenger motor vehicles, components and replacement parts will be held at 15 per cent between 2000 and 2004 and reduced to 10 per cent on 1 January 2005. (The tariffs on four wheel drive and light commercial vehicles will remain at 5 per cent.)
- Tariffs in the TCF sector will be held at their July 2000 levels until January 2005, then reduced from 25 per cent to 17.5 per cent on clothing and finished textiles, from 15 per cent to 10 per cent on footwear and fabrics and from 10 per cent to 7.5 per cent on sleeping bags and table linen. Items within this sector currently dutiable at general rates of 5 per cent will continue at that rate.

These tariff arrangements are linked to broader measures intended to facilitate restructuring as outlined in box 4.2. The Government has indicated that PMV and TCF tariffs are to be reviewed again in 2005.

Some participants advocated, not without reason, that a review of tariff assistance provided to the PMV and TCF industries should be conducted earlier than that presently scheduled for 2005. The Australian APEC Study Centre stated:

> Post 2005 policy on tariffs for PMV and clothing and textiles should not be left for determination until 2005. If companies are uncertain about what will follow in 2005, business decisions affecting investment in the period after 2005 will be deferred. … The Productivity Commission should recommend to the Government that those decisions should be taken earlier, preferably in 2000 so that business has sufficient time to plan for the post 2005 environment. (sub. 48, p. 4)

The Australian Electrical and Electronic Manufacturers' Association (AEEMA) commented:

> Given the high rates of tariffs applying in the PMV and TCF sectors already attracts adverse comment in international trade negotiations — sometimes to justify measures imposed against Australian products — it seems to make little sense to delay discussions about them post-2005. (sub. 41, p. 20)

Box 4.2 **Post-2000 PMV and TCF development plans**

PMV industry package

- A review of tariffs in 2005, taking into account APEC commitments and progress on market access.
- Continuation of the Duty Free Allowance at 15 per cent.
- The Automotive Competitiveness and Investment scheme — designed to be a WTO consistent program replacing the Export Facilitation Scheme and projected to provide benefits averaging $300 million a year over the period 2001 to 2005.
- The Automotive Market Access and Development Strategy including a new Automotive Trade Council, an automotive market facilitator in DFAT and an automotive market access and development fund of $20 million over four years.
- An environmental strategy to phase out leaded fuel by 2010 and an industry code of environmental performance.

TCF industry package

- A review of tariffs in 2005, taking into account APEC commitments and progress on market access.
- The development of action agendas for wool, cotton, leather and fashion.
- The TCF Strategic Investment Program to commence on 1 July 2000 — a five year $700 million investment incentive scheme to encourage further investment in the wool, cotton, leather and fashion industries.
- A $10 million TCF Technology Development Fund to operate for five years from 1 January 1999.
- Funding support under the National Framework for Excellence in the TCF Training Program.
- A Market Development Program with funding of $2.5 million annually.
- An expanded Overseas Assembly Program to enable increased use of Australian textiles.

Sources: Howard and Moore (1997) and Howard, Costello, and Moore (1997).

Effects on other manufacturing industries of the schedule for PMV and TCF tariff reform

The PMV and TCF sectors continue to receive substantially higher assistance than manufacturing generally (see table 2.5 and figure 2.3). For example, the Commission has estimated that from 1 July 2000 the level of assistance afforded to the TCF and PMV sectors, in effective rate terms, will be 26 per cent and 20 per cent, respectively, compared with the manufacturing average effective rate (excluding the PMV and TCF sectors) of 3 per cent.

A number of inquiry participants commented on the large differences between tariffs for the PMV/TCF industries and for other parts of the manufacturing sector. Some argued that general tariffs for goods under reference should not be reduced while high assistance continues for the PMV and TCF sectors. For instance, the Pulp and Paper Manufacturers Federation of Australia stated:

> As a matter of principle, whatever levels of tariff protection are applied across sectors in Australia should be applied equally. For example, it is inequitable that some sectors of manufacturing industry (PMV and TCF) receive substantially higher levels of protection, and indeed, are not even subject to this review. (sub. 47, p. 5)

The largest impact of the high PMV and TCF tariffs falls on those industries whose inputs include a relatively large proportion of outputs from either the PMV or TCF sectors.

Submissions by the furnishing and brushware associations indicated that, as major users of textile products, they would be disadvantaged by a reduction in the general tariff while tariffs on their textiles inputs remained high. In presenting estimates of the extent of this possible disadvantage, the National Furnishing Industry Association commented that:

> A differential between tariffs on major inputs and finished products has a direct impact on local producers. This is the situation for Australian furniture manufacturers, which use textiles, as a major manufacturing input. The furnishing industry is paying well over market rates for this key input (textiles) because they are protected by high tariffs. Whilst some compensation is provided by the 5% finished good tariff the situation will become significantly worse should the finished good tariff be removed. (sub. 28, p. 2)

Similarly, the Brushware Manufacturers’ Association of Australia stated:

> With the duty on so much of the modern fibres/filaments frozen by the Government … the Australian brushware industry sees it as inequitable to permit input costs and output prices to be artificially distorted to a material degree — especially since these input costs are a major, if not the major, cost element. … Consequently a pause is considered advisable; and it seems logical that it continue until Tariff Chapter 54 (fibres/filaments) comes up for review since, to do otherwise, would worsen the economic distortion. (sub. 37, pp. 5, 7)

Certainly, firms and industries which are relatively heavy users of PMV and TCF products are more likely to be disadvantaged by reductions in general tariffs for goods under reference than other industries, at least in the period to 2005. Table 4.5 illustrates the potential impact on effective rates of assistance for manufacturing industries of a removal of general tariffs for goods under reference.

Table 4.5 **Average effective rates of assistance, manufacturing[a] and potential effects of the removal of the general tariff**

per cent

ANZSIC industry	*1996-97*	*2000-01[b]* Current arrange-ments	*2000-01[b]* Removal of tariffs under reference	*2005-06[b]* Current arrange-ments	*2005-06[b]* Removal of tariffs under reference
Food, beverages & tobacco	4.4	4.2	1.3	4.2	1.3
Textiles, clothing, footwear & leather	32.2	21.3	21.9	14.7	15.2
Wood & paper products	5.5	5.5	-0.1	5.6	-0.1
… of which furniture	4.8	5.0	-0.4	5.2	-0.3
Printing, publishing & recorded media	0.9	0.9	-0.1	0.9	0.0
Petroleum, coal, chemicals & associated products	4.5	4.5	0.7	4.3	0.5
Non-metallic mineral products	2.7	2.6	0.1	2.6	0.1
Basic metal products	3.6	3.6	0.0	3.6	0.0
Fabricated metal products	4.6	4.5	0.2	4.4	0.1
Motor vehicles and parts	21.3	14.5	13.3	9.8	8.6
Other vehicles	-0.7	-0.6	-0.1	-0.6	-0.1
Other machinery and equipment[c]	2.7	2.2	0.3	2.1	0.2
Other manufacturing	4.8	4.8	-0.2	4.8	-0.1
Total manufacturing	**5.8**	**5.0**	**2.2**	**4.4**	**1.6**

[a] Estimates differ fractionally from those presented in earlier Commission studies. The main reason is an updating of industry output and input weights. [b] Rates at 1 July 2000 and 1 January 2005 are assumed to apply for the periods 2000-01 and 2005-06 respectively. [c] Separate updated estimates are not available for the PMV sector — the industry 'motor vehicles and parts' includes other forms of transport equipment such as trucks and buses.

Source: PC estimates.

For sectors other than TCF and PMV the removal of general tariffs for goods under reference would reduce effective rates to around zero. The differences between the estimates for 2000-01 and 2005-06 are due almost entirely to the further reductions in PMV and TCF tariffs scheduled on 1 January 2005.

The Commission's estimates indicate that, pending further reductions in tariffs for the PMV and TCF sectors, some industries, such as furniture and brushware would be more adversely affected by reductions in general tariffs than others. However, the estimated effect is small and not sufficient to justify a departure from an 'across-the-board' approach to general tariff reductions for goods under reference.

Implications for PMV and TCF of reductions in general tariffs

Like other sectors, the PMV and TCF sectors use a wide range of Australian produced and imported goods and services in production. For example, in 1994-95 intermediate inputs for PMV and TCF were valued at $10 billion and $8.6 billion, respectively. Although PMV and TCF producers obtain a high proportion of intermediate inputs from their own sectors, a variety of other industries also supply inputs (table 4.6).

Table 4.6 **Intermediate inputs: PMV and TCF industries, 1994-95**

Manufacturing industries accounting for more than 1 per cent of PMV/TCF inputs

Motor vehicles and parts			*Textiles, clothing, footwear and leather products*		
Major intermediate inputs	*Value*	*Per cent of total intermediate inputs*	*Major intermediate inputs*	*Value*	*Per cent of total intermediate inputs*
	$m	%		$m	%
Motor vehicles and parts	4390	43	Textiles	3309	39
Iron and steel	1235	12	Knitting mill products	602	7
Fabricated metal products	284	3	Leather and leather products	392	5
Basic non-ferrous metals	274	3	Meat and meat products	208	2
Rubber products	239	2	Basic chemicals	150	2
Paints	162	2	Plastics	107	1
Basic chemicals	130	1			

Source: ABS (1999a).

A reduction in general tariffs for goods under reference (before the further PMV and TCF reductions scheduled to be made in 2005) would benefit the PMV and TCF sectors through lower input costs. This would raise the effective assistance already accorded to these highly assisted industries.

Some participants believed this would be undesirable. For example, AEEMA said:

> It has been argued that any reductions in the general rate of tariffs post–2000 will confer additional benefits on the more highly protected PMV and TCF sectors, further increasing the larger rates of effective assistance enjoyed by those sectors.
>
> AEEMA agrees with this view and believes the net result of such an increase in the effective rate of assistance to PMV and TCF producers may diminish overall community welfare. (sub. 41, p. 20)

As shown in table 4.5, the increase in the effective rate of assistance for the TCF sector would be small (about half a per cent). Of greater significance for community welfare are the scheduled TCF tariff reductions in 2005 which will result in assistance to the sector falling from 21 per cent in 2000-01 to about 15 per cent in 2005-06.

Similarly, although separate estimates are not available at this stage, the effective rate for the PMV sector could be expected to increase marginally if general tariffs under reference were removed. Here also, the January 2005 tariff reductions would have a more noticeable effect on the effective rate for the PMV sector.

An increase in assistance levels in the TCF and PMV sectors, from the removal of tariffs under reference would coincide with a decline in the manufacturing average effective rate of assistance — from 5 per cent currently to 2.2 per cent in 2000-01 and 1.6 per cent in 2005-06 (table 4.5).

Overall, there would be an initial widening in the effective rate differential between the PMV and TCF sectors on the one hand, and those industries currently assisted by the general tariff on the other. For example, currently the difference between the effective rate of assistance on TCF and total manufacturing is 16 percentage points. If tariffs under reference were removed, the absolute difference is estimated to increase to nearly 20 percentage points. However, the difference would be higher only in the short term — by 2005 it would be less than the current differential (table 4.5).

Any adverse resource allocation consequences for the community associated with additional assistance provided to the PMV and TCF sectors by reductions in general tariffs before 2005 would be lessened to the extent that those sectors have already factored into their planning the consequences of the scheduled reductions in their tariffs in 2005. It is possible, however, that the legislated tariff reduction pause for the PMV and TCF industries might have the effect of holding, in those sectors, resources which might otherwise have moved out during the 2000–2005 period.

4.3 Tariff lines for which there is no significant Australian production

The Commission has been asked to identify and report on the costs and benefits of removing tariffs on tariff lines at the 8-digit level for which there is no significant Australian production. This again raises the related issue of whether benefits to the community overall are maximised by uniform across-the-board reductions in general tariffs, or whether those benefits are maximised through 'fine-tuning' by reducing tariffs only where there is no significant local production to protect.

Some participants explicitly endeavoured to define a meaning for 'no significant local production'. Qenos indicated that it probably meant 'a loose form of no Australian production' (trans., p. 81). The AIG indicated that it had worked 'to ensure that where known Australian local manufacturers exist, that duty is not removed …' (sub. 63, p. 12). Other participants, taking a lead from the recent 'nuisance tariff' exercise (see section 1.1), indicated that tariffs could be removed where the annual duty on importation was less than $100 000. Some participants submitted lists of products for which they considered there was no significant local production. For example, Crown Equipment's list included 'fork lift trucks, narrow aisle trucks and turret trucks classified to 8427.10.00 and 8427.20.00 and hand pallet trucks classified to 8427.90.00 (statistical key 09) of the Customs Tariff …' (sub. 90, p.1).

Irrespective of the meaning given to 'significant local production', it is not possible to identify corresponding 8-digit tariff lines from published or unpublished statistical data. Accordingly, the following analysis of costs and benefits is generic rather than line-by-line.

In terms of the possible assistance effects, reduction of the general tariff for a particular item (while other general tariffs remain unchanged) may have a positive or negative outcome depending on whether that item is a consumer good, or, if a business input, whether the using industry is relatively heavily or lightly assisted. (This conclusion is explained at more length in section 6.2 which deals with the assistance benefits and costs of the Tariff Concession System.) There is no a priori certainty that the removal of general tariffs for a particular group of items — say for those for which there is no significant Australian production — would automatically improve the structure of assistance. In any case, there would be some Australian production of most items for which general tariffs of 5 per cent still remain.

From an administrative point of view, item-by-item assessment can lead to a number of problems, especially given the lack of data about Australian production at the level of detail which would be required for such an exercise. Several participants criticised the 'nuisance tariff' review in this respect. ISONET (sub. 56, pp. 6–7) gave an example of the unintended consequences of ad hoc tariff removal and said this should be contemplated only 'following rigorous analysis and consultation with potential affected companies, and detailed advice from experts in the field'. Colan Products (sub. 66) indicated that the tariff had been removed on imports of woven fabrics of rovings despite the fact that it manufactures those products in Australia. AEEMA indicated that:

> care should be taken to ensure that those tariffs that are abolished in this context are actually 'nuisance tariffs'. Unfortunately, AEEMA and its members have direct experience of administrative errors leading to changes in the tariff treatment of certain products that the Government had not intended to change. (sub. 41, p. 18)

The Commission considers that any further general tariff reductions should be uniform across all goods under reference, rather than piecemeal, as this would maximise efficiency gains by reducing disparities in assistance as well as reducing the average level of assistance. It would also minimise the possibility of causing unintended increases or decreases in the effective assistance accorded to particular activities by increasing the difference between tariffs on outputs and inputs or through administrative error.

5 International developments and trade arrangements

This chapter considers how changes to Australia's general tariffs may interact with international economic and trade developments of significance to Australia and Australia's ability to take advantage of such developments. It also discusses the implications of any reduction in general tariffs for Australia's existing preferential trade agreements and for Australia's interests in current and prospective trade liberalisation arrangements.

5.1 International economic and trade developments

Considerable technological change and policy reforms in the recent past have facilitated a significant increase in international trade in goods and services and in international flows of capital. These developments (outlined below) are likely to continue and to encompass countries not currently embracing them or at least not to the same degree. Evidence of this is to be found in the reforms introduced in the former USSR countries, China, India and, following the 1997 economic crisis, in several other Asian economies. A result has been more open and competitive international markets for goods, services and capital. There has also been renewed debate, with broader participation, about the effects of more open markets.

Multilateral arrangements for the liberalisation of trade barriers, to which Australia is party (negotiated with regard to the system of rules governing international trade under the aegis of the World Trade Organization (WTO)), have facilitated increased trade in goods and services. In addition, regional and bilateral arrangements (eg ASEAN Free Trade Agreement, North American Free Trade Agreement) are also facilitating increased international trade insofar as they have generally encouraged economic growth and development, although their narrower focus raises the potential for trade diversion as well as trade creation. The trade liberalisation engendered by negotiated agreements has been supplemented by many countries acting unilaterally to reduce tariff and non-tariff barriers in recognition of the gains accruing to their own economies (see box 5.1).

Box 5.1 Examples of recent unilateral and negotiated trade reforms

Unilateral reforms

Indonesia: following the onset of the East Asia crisis in the late 1990s, tariffs on most food items were cut to a maximum of 5 per cent; all tariffs, import controls and domestic subsidies eliminated on wheat, sugar and soybeans; and a commitment to phase out all remaining quantitative import restrictions and other non-tariff barriers.

Korea: also since the onset of the East Asia crisis, there has been a progressive phasing-out of the Import Diversification Program banning importation of certain goods; reduction of tariffs on a number of items including industrial inputs (to zero or near-zero levels) and foodstuffs.

Malaysia: a range of tariff reductions announced in November 1999 on food and manufactured/industrial products, including fruit, vegetable, dairy and seafood products of significant value to Australian exporters.

Thailand: tariffs on cotton and wool completely removed following a comprehensive review of tariffs in August 1999; tariffs on lupins reduced from 35 to 5 per cent; tariffs on plywood, veneered panels and laminates reduced from 60 to 20 per cent; and removal of a 10 per cent surcharge, which had applied to most imports.

China: has undertaken an extensive range of reforms in preparation for gaining entry to the World Trade Organization. Between 1992 and 1998, China's weighted average tariffs fell from 40.6 per cent to 18.7 per cent, with further reductions to follow.

Reforms negotiated bilaterally with Australia

The Phillipines: A tariff bias favouring ASEAN countries for sugar was removed. Queensland Sugar Corporation subsequently won a major contract to supply sugar worth more than $30 million.

Mexico: A phytosanitary (plant health) agreement has been negotiated, allowing Australian canola exports to reach $60 million in 1999, following initial 1998 sales of $9 million.

Poland: A waiver of the 30 per cent tariff on greasy and scoured wool imports of 24 microns and coarser was agreed for the year 2000, enabling Australian exporters to maintain access to the Polish market.

Source: DFAT, sub. 65, pp. 23–4 and DFAT (2000b).

While protection of some industries in other countries remains substantial, the general trend has been towards reduced trade barriers in most areas. As shown in table 5.1, average tariffs on manufactured products declined substantially in most countries which are major trading partners of Australia during the 1990s. Australia was not alone in making substantial reductions to tariffs on manufactures.

Table 5.1 **Average tariffs for manufactured products, selected countries**
weighted mean tariff

Country	*Average - 1993*	*Average - 1999*	*Percentage reduction*
	%	%	%
OECD countries			
Australia	9.7	4.2	57
Canada	8.0	2.9	64
New Zealand	9.4	3.4	64
Japan	(1998) 1.5	2.0	+33
Republic of Korea	(1996) 7.8	7.0	10
United States	(1995) 4.4	2.4	46
European Union	(1994) 7.0	3.2	54
Other countries			
China	44.0	(1998) 18.5	58
India	(1997) 29.5	28.0	5
Indonesia	25.4	14.3	44
Malaysia	12.6	(1997) 9.4	25
Philippines	21.0	8.5	60
South Africa	16.9	5.5	68
Taiwan	(1996) 6.5	na	na
Thailand	43.7	na	na

na – not available.

Source: World Bank (2000).

Associated with the reduction in trade barriers has been a continual expansion of world trade in which Australia has participated actively. Total Australian merchandise exports and imports increased by 95 per cent and 108 per cent, respectively, between 1988-89 and 1998-99. Trade with all broad regional areas expanded over this period. As shown in figure 5.1, Australian exports to ASEAN countries and Korea, after growing strongly during most of the 1990s, declined in 1997-98 and 1998-99 as a result of the economic crises experienced by those economies. The declines were partially offset by increases to European Union and North American countries.

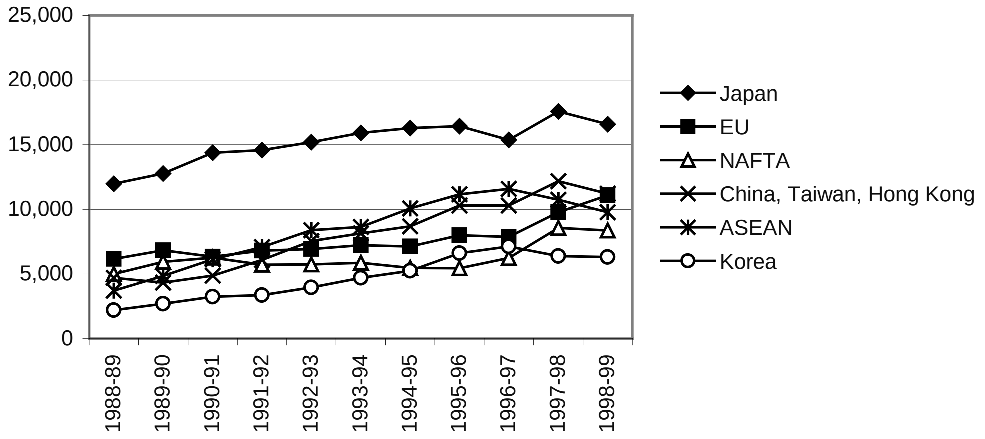
During the 1990s, the European Union and North America continued to be the major sources of Australian imports (figure 5.2). The most rapid growth of imports in this period, however, was from ASEAN countries.

The extent of the reduction of maximum tariffs in overseas countries was noted by DFAT:

> … the average bound tariff facing Australia’s exports of industrial products is now less than 2 per cent on a trade weighted basis, while nearly 50 per cent of Australia’s exports now have tariff-free access to significant markets. (sub. 65, p. vi)

Figure 5.1 Australian exports to major countries and groups, 1988-89 to 1998-99

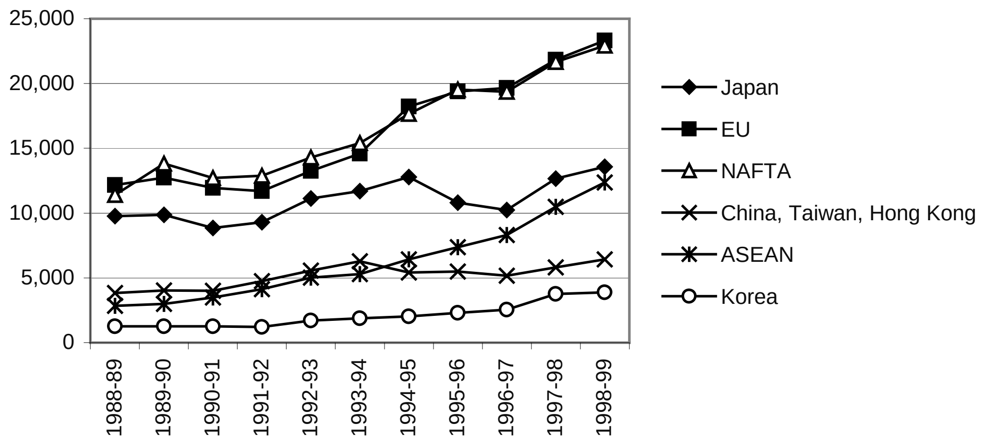
$ million



Source: DFAT (2000a).

Figure 5.2 Australian imports from major countries and groups, 1988-89 to 1998-99

$ million



Source: DFAT (2000a).

After the Uruguay Round reductions are fully implemented, Australia's trade-weighted average bound rates will be around 10 per cent. As outlined in chapter 2, Australia's bound rates are considerably higher than the tariffs actually applied in most areas.

In many countries, nonetheless, there remain significant tariff peaks, tariff escalation and other barriers to trade. Whereas Australia makes little use of non-tariff barriers, apart from quarantine, they are a significant impediment to trade elsewhere — especially for food and agricultural commodities. However, Australia has been among the major users of anti-dumping actions and this tends to decrease the level of openness of economy.

Participants, such as the AIG (sub. 63), provided and referred to evidence of the tariff and non-tariff barriers that still constitute a major impediment to particular markets for some Australian exporters (see table 5.2). In particular, the AIG noted that non-tariff barriers posed major problems in many markets. In this regard, DFAT (sub. 65) said that any proliferation of non-trade measures (eg price controls, import licensing arrangements and technical standards) by Australia's trading partners could undermine or negate the value of tariff reductions.

Table 5.2 **Non-tariff barriers, OECD countries**

per cent

Country	*Frequency ratio*[a]			*Import coverage ratio*[b]		
	1988	1993	1996	1988	1993	1996
United States	25.5	22.9	16.8	16.7	17.0	7.7
European Union	26.6	23.7	19.1	13.2	11.1	6.7
Japan	13.1	12.2	10.7	8.6	8.1	7.4
Canada	11.1	11.0	10.4	5.7	4.5	4.0
Norway	26.6	23.7	4.3	13.8	11.1	3.0
Switzerland	12.9	13.5	7.6	13.2	13.2	9.8
Australia	3.4	0.7	0.7	8.9	0.4	0.6
New Zealand	14.1	0.4	0.8	11.5	0.2	0.2
Mexico	2.0	2.0	14.6	18.6	17.4	6.9

a The frequency ratio is the proportion of national tariff lines that are affected by a particular non-tariff barrier (NTB) or by a specified group of NTBs, irrespective of whether the products affected are actually imported. **b** The import coverage ratio is the share of a country's own imports that is subject to a particular NTB or any one of a specified group of NTBs.

Source: OECD (1999).

More generally, international economic and trade developments have been influenced by increased deregulation by countries of major sectors of their economies (eg electricity, water, gas, and telecommunications). This has improved efficiency and fostered growing direct participation in those sectors through investment by foreign corporations. Reduced restrictions in domestic capital markets and on capital inflow and outflow have stimulated this participation.

Overlaying these reforms have been significant improvements in technology (eg in transport, communication and computing). Technological change has lowered the cost of delivering goods and services, facilitated the exchange of ideas and raised the efficiency of producers.

DFAT considered that as a result of such changes:

> … increased global competition is evident across all areas of economic activity. For instance, developed economies, and even some emerging economies, are becoming increasingly services-oriented, introducing an increasing level of supply and competition in services trade. (sub. 65, pp. 25–6)

A more competitive environment for goods, services and capital will, in turn, place greater pressure on Australian firms. It will also maintain pressure on governments in Australia to implement policies which foster improved productivity and competitiveness. As noted by the Secretary-General of the OECD:

> Globalisation is not a policy; it is a process which will affect all aspects of our lives. We may not like it; after all, it can compel us to give up cosy habits. But to stand against it would be sheer folly. Still, some believe they can somehow resist the powerful tide of globalisation. … those who cling to protectionism to preserve jobs … forget that by their actions they drive up prices and actually destroy jobs … (Johnston 1999, p. 3)

Similarly, the National Farmers' Federation noted that:

> Only by a continuing commitment to trade liberalisation can the Government ensure that Australian industry and farmers can take advantage of the long-term trend towards globalisation. Australia must continue to reduce and eventually eliminate all import barriers if we are to compete effectively with other countries. (sub. 76, p. 4)

An implication of these international economic developments is that further reductions in Australia's general tariffs would help to strengthen the international competitiveness of efficient domestic producers, enabling them to take full advantage of the opportunities that globalisation offers. Many participants, however, did not favour this approach, arguing instead for a pause in tariff reductions until other countries 'catch up' to Australia or for Australia to link its reductions in barriers to trade with those of other countries (the 'reciprocity' argument). The South Australian Government for example, said:

> It is illogical to further reduce protective tariffs when few of our major trading partners have done so or to the same extent over the past decade. (sub. D150, p. 4)

These arguments are addressed below in section 5.4.

5.2 Trade arrangements

The existing and potential trade arrangements of most relevance for Australia's goal of trade liberalisation are those under the aegis of the WTO — which replaced the General Agreement on Tariffs and Trade (GATT) — and the Asian Pacific Economic Cooperation (APEC) forum. Of less significance, but still important, are Australia's preferential trade arrangements — bilateral agreements with New Zealand, Papua New Guinea, the Forum Island Countries, Canada and general developing country tariff preferences. (Currently, Australia is also involved in a study assessing the feasibility of a comprehensive free trade agreement involving ASEAN economies, Australia and New Zealand by 2010.[1])

World Trade Organization

The WTO operates a system of 'rules' for regulating international trade and encouraging reductions in trade barriers (see box 5.2). WTO members (now 136 in total) commit to 'binding' their tariff rates on products at agreed (negotiated) levels, and eliminating or reducing other trade-distorting measures covered by the various articles and agreements. These agreements prohibit non-tariff barriers such as quotas and import bans, as well as activities such as local content schemes and export subsidies for non-agricultural products.

The WTO system, with countries committed not to impose tariffs higher than the bound rate, has achieved significant reductions in actual tariff rates. The WTO allows for preferences for developing countries. It also permits regional free trade agreements that meet WTO requirements (such as the Australia–New Zealand Closer Economic Relations Trade Agreement).

WTO negotiations on agriculture and services were mandated to begin in 2000 under the 'built-in agenda' established under the Uruguay Round, and preparations to facilitate these negotiations under that timetable are well advanced. However, the latest WTO Ministerial Conference (in Seattle in late 1999) failed to achieve consensus on the basis for a more comprehensive new round of multilateral negotiations.

The benefits arising from the operation of the WTO in freeing up international trade and access to markets are likely to increase significantly in the near future with the proposed admission of China and a number of other countries, including Taiwan, to the WTO later this year. Australian exporters of goods and services in the

[1] An assessment of the economic impact on member-country economies is provided by Davis, McKibbin and Stoeckel (2000).

agricultural, manufacturing and services sectors will gain from the substantial improvement in market access negotiated as part of that process. As noted by Australia's Minister for Trade:

> China's WTO membership will open significant new trade opportunities for Australian exporters. The bilateral deal with Australia covers more than 1000 product categories across key agricultural and manufacturing exports, as well as major service sectors such as banking and insurance. (Vaile 2000a.

Box 5.2 **The World Trading System: fundamental principles**

The WTO is the international body that deals with the rules of international trade. It oversees the agreements which provide the legal ground-rules for international commerce.

The Organization's overriding purpose is to increase global economic welfare through the expansion of international trade. One of the WTO's most important functions is to provide a forum for multilateral trade negotiations. The resolution of trade disputes through the WTO's dispute settlement system is also a vital part of its framework of rules.

According to the underlying principles of the WTO agreements, the world trading system should be:

- without discrimination — a country should not discriminate between its trading partners (they are all, equally, granted 'most-favoured-nation' status); and not discriminate against foreign products and services. Exceptions are permitted under certain conditions: preferential regional trade agreements are a notable exception;
- freer — with trade barriers and other distortions coming down through negotiation;
- predictable — foreign companies, investors and governments should be confident that trade barriers (including tariffs, non-tariff barriers and other measures) should not be raised arbitrarily; increasingly, tariff rates and market-opening commitments are 'bound' in the WTO;
- competitive — by discouraging 'unfair' practices such as export subsidies and dumping products at below cost; and
- more beneficial for less developed countries — by giving them more time to adjust, greater flexibility, and special privileges.

Source: DFAT, sub. 65, p. 6.

The Asia Pacific Economic Cooperation forum

Since its inception in 1989, APEC has assumed a significant role in promoting trade facilitation and liberalisation, at the same time as its members pursued trade barrier reductions under the auspices of the GATT and, more recently, the WTO. APEC countries accounted for 73 per cent of Australia's merchandise exports in 1999 and its members account for around 40 per cent of world trade.

There has been substantial progress with tariff liberalisation in the Asia–Pacific region over the past decade. In part, this has occurred through negotiated tariff reductions. But much has come from unilateral tariff reforms as economies have recognised the gains in economic growth arising from trade liberalisation. Applied tariffs have declined faster than tariff commitments bound under the WTO.

A significant milestone was the Bogor Declaration, made by APEC leaders in November 1994. It commits industrialised APEC economies (including Australia) to achieving 'free and open trade and investment' no later than 2010, with non-industrialised APEC members to do so by 2020. Australia's commitment to the Bogor Declaration was confirmed in the White Paper on Australia's Foreign and Trade Policies, *In the National Interest*, released in August 1997 (DFAT 1997).

APEC members agreed to the Bogor Declaration because they recognised that an open multilateral trading system provides a secure international basis for the pursuit of comparative advantage and economic specialisation which, in turn, enhances economic growth and the improved welfare that it makes possible.

To provide an open and transparent record of their commitment to this goal, each APEC member is obliged to report annually on initiatives to achieve these goals. These reports are contained in their annual Individual Action Plans. The first of these were submitted to the APEC Ministerial Meeting held in Manila in November 1996.

At their meeting in September 1999 in Auckland, APEC leaders pledged to strengthen markets and improve the international framework governing trade and investment flows. Leaders also reaffirmed their commitment to the Bogor goals of free and open trade and investment by 2010–2020. There is, however, no definitive statement by APEC governments on the meaning of the term 'free and open'.

At their latest meeting in Darwin in June 2000, APEC trade ministers called for an early launch of a new WTO round. As announced by the Minister:

> This year the majority of APEC member economies reported significant tariff reductions and many have taken steps to reduce non-tariff measures. Most have taken measures to liberalise their investment regimes, improve competition policy and deregulate their economies. There has also been extensive work done to streamline customs procedures and harmonise standards. (Vaile 2000b)

Preferential agreements

Australia has preferential trading arrangements with a number of countries. The Australia–New Zealand Closer Economic Relations Trade Agreement provides for reciprocal free trade between Australia and New Zealand. Agreements with members of the South Pacific Forum Island Countries and Papua New Guinea also provide for duty free entry into Australia of goods meeting relevant rules of origin. Australia also provides tariff preferences for some products under the Canada–Australia Trade Agreement. In addition, under the Australian System of Tariff Preferences, many goods originating in developing countries attract preferential (ie reduced) rates of duty. The value of these preferential tariffs has been eroded in recent years, however, as a consequence of the reduction in Australia's tariffs over this period.

The Australia–New Zealand Closer Economic Relations Trade Agreement (CER)

The CER Trade Agreement aims to develop closer economic relations between Australia and New Zealand through a mutually beneficial expansion of free trade under conditions of fair competition and through the gradual and progressive elimination of barriers to trade between the two countries. All tariffs and quantitative import or export restrictions on trade in goods originating in the Free Trade Area are prohibited under the CER Agreement.

The preferential access which Australian goods gain under CER is now modest. New Zealand's remaining applied tariffs are generally low (except for textiles, clothing and footwear). In 1998, New Zealand implemented a tariff reduction program to achieve zero tariffs by 2006. However, New Zealand's new government (elected in November 1999) has announced that it will retain remaining tariffs at year 2000 levels until 2005.

The South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)

Australia's (and New Zealand's) trade and economic relations with the Forum Island Countries (FICs) are conducted under the aegis of SPARTECA. This provides a framework for assisting FICs with their economic development and trade performance and, subject to meeting a 50 per cent local or area content rule, FIC exporters are eligible for free and unrestricted access to the Australian (and New Zealand) markets for virtually all products.

SPARTECA's value to FICs has been diminishing because the overall decrease in tariff rates in Australia has removed much of the preference margin that is its main benefit. Even with further reductions in general tariffs, however, it would still be of value because of the preferential access it provides for textiles, clothing and footwear (of particular importance for Fiji).

At the Pacific Island Forum in October 1999, Leaders endorsed a recommendation by the Forum Trade Ministers that a Pacific Regional Trade Agreement be negotiated over the next two years. Australia and New Zealand, as members of the Pacific Island Forum, will be included in the agreement 'in appropriate ways'. Negotiations were expected to commence in June/July 2000.

Agreement on Trade and Commercial Relations between the Government of Australia and the Government of PNG (PATCRA II)

PATCRA II seeks to strengthen trade, investment and private sector cooperation between Australia and Papua New Guinea, in the context of the close trading and commercial relationship. It aims to ensure that the relationship is mutually beneficial and takes account of the capacity, resources and development needs of both countries. Under it, Papua New Guinea receives duty free entry into Australia for goods meeting relevant rules of origin.

The Canada–Australia Trade Agreement (CANATA)

CANATA, which was negotiated in 1960 and amended in 1973, provides preferential access for bilateral trade between Canada and Australia on a range of specified goods.

The value of the preference over the Most Favoured Nation rate varies from 1 per cent (for some fruits and vegetables and lumber) to 15 per cent (for car batteries). While it continues to provide benefits to both countries, its significance has declined as a result of sweeping reductions in tariff rates in both countries and as patterns of trade have changed since the items of merchandise covered by preference were first agreed.

The 1973 Ministerial Exchange of Notes amending CANATA established a 30 day notification and consultation procedure whereby either party could reduce or eliminate CANATA tariff preferences. In the event that one party proposes to reduce tariffs on goods covered by CANATA, that party should provide 30 days advance notice, during which time (depending on the category of good) the other party is entitled to consult. If the proposed reduction goes ahead, the other party would be entitled to withdraw 'substantially equivalent concessions'.

If changes in the Australian general tariff were to negate Canadian preferences under CANATA, Australia's preferential access to the Canadian market could also be affected.

The Australian System of Tariff Preferences

Preferential tariff arrangements for developing countries were formalised in the GATT through a decision of 25 June 1971 which granted a waiver to preference-giving countries in accordance with the Generalised System of Preferences. That decision recognised that the principal aim of preferences to developing countries should be to promote their economic development. The GATT noted that granting preferences did not constitute a binding commitment and that it should be a temporary measure.

The Australian System of Tariff Preferences was introduced in 1965. It was one of the models on which the Generalised System of Preferences was based. A tariff preference of 5 percentage points was initially applied to imports of all goods from any developing country. Over time, Australia has modified its preferences to reflect improved economic performance among developing countries. A preference of 5 percentage points now applies to only 48 countries identified by the United Nations as Least Developed Countries and a number of other small island developing countries and territories.

For these beneficiary countries, this results in duty-free access for most products (about 85 per cent of tariff lines), either because the general tariff rate is zero or through the 5 percentage point tariff preference. The preferential tariffs are higher than zero for textiles, clothing and footwear, automotive sector items and cheese. As noted above, Australia also provides duty free access for virtually all imports from Forum Island Countries — most of which are not Least Developed Countries.

Further reductions in general tariffs (ie all tariffs of 5 per cent or less and excluding those relating to passenger motor vehicle and textile, clothing and footwear items) would not increase the number of tariffs with a zero rate faced by Least Developed Countries (DFAT sub. 65, p. 39). Moreover, the value of trade covered by the Australian System of Tariff Preferences is limited. In 1998, for example, total imports from the Least Developed Countries — excluding textile, clothing, footwear and automotive items which are not under reference in this inquiry — were valued at $86 million. (Including textiles, clothing, footwear and automotive items, total imports were valued at $112 million.)

5.3 Implications for Australia's trade agreements

A decision by Australia to reduce its general tariffs to zero would be entirely consistent with its commitments under the Bogor Declaration. It would also have some implications for existing preferential arrangements involving Australia (see box 5.3). However, with the one possible exception of the agreement with Canada, such a unilateral reduction in general tariffs would present no significant difficulties for Australia. For that agreement, advice from DFAT is that any potential repercussions would be minor.

Box 5.3 **Implications of unilateral reductions in general tariffs for Australia's preferential trade arrangements**

As outlined by DFAT (sub. 65), reductions in Australia's general tariff would weaken New Zealand's price advantage for some goods in the Australian market relative to competing economies. However, it would not adversely affect bilateral relations with New Zealand or the strength of CER (p. 36). Implementation of unilateral tariff reductions on a most-favoured-nation basis would be consistent with the trade liberalisation policies pursued by both countries.

Further reductions in general tariffs would not cause problems in Australia's relations with the Forum Island Countries under SPARTECA. Those countries would still benefit from the preferential access it provides to passenger motor vehicle and, importantly, textile, clothing and footwear items (p. 37).

Reductions in Australia's general tariff would be unlikely to have a negative impact on the bilateral relationship with Papua New Guinea under PATCRA II (p. 37). Neither would it cause problems for least developed economies and other small developing economies benefiting from the Australian System of Tariff Preferences (p. viii).

There could be some minor consequences under the trade agreement with Canada (p. viii). Under the agreement (CANATA), either side is free to remove a preference, but it is open to the other to withdraw a substantially equivalent concession. If changes to the Australian general tariff were to negate Canada's preferences under CANATA, Australia's preferential access to the Canadian market could be affected.

Source: DFAT, sub. 65.

5.4 Implications for trade liberalisation

There were differing views about whether the timing of further reductions in Australia's general tariff should be linked to actions taken by other countries to reduce their own trade barriers.

A number of participants considered that Australia should reduce remaining general tariffs as soon as possible, irrespective of the actions of other countries. These participants considered that delaying reductions by Australia in the hope of obtaining reciprocity from other countries would also postpone the realisation of benefits for Australia of trade liberalisation. For example, the Chamber of Minerals and Energy of Western Australia (sub. D109), the National Farmers' Federation (sub. 76) and the NSW Farmers' Association (sub. 77) noted that delaying reductions in general tariffs would prolong the cost impost on Australian consumers and industries of tariffs on the goods they consume or use as inputs. The Chamber of Commerce and Industry Western Australia submitted that:

> Australian trade representatives should continue to pursue cuts in our trading partners' tariff barriers. But to forgo the certain benefits of unilateral tariff cuts now in the hope of uncertain benefits from reciprocal cuts in future would seem an unnecessary gamble, and foolish if it is based on an inflated expectation of our bargaining clout. (sub. D133, p. 1)

The Australian Chamber of Commerce and Industry saw some value in tariffs as negotiating coin:

> given the world trading environment and the need to have tangible negotiating coin in the WTO and APEC context, it would be better to use the further reductions in Australian tariffs to leverage lower protection levels amongst our trading partners. (sub. D153, p. 1)

However, it also recognised that 'there are gains to be made through unilateral reductions in tariffs' and ultimately recommended that:

> 'General tariffs be reduced in the context of multilateral negotiations on 1 January 2005 at the latest'. (sub. D153, p. 1)

A majority of participants, however, considered that Australia should wait for other countries to reduce their own trade barriers before reducing its remaining tariffs. The PACIA (subs 40 & D123), PPMFA (sub. 47), AIG (subs 63 & D122), the NSW Minister for Small Business (subs 95 & D143), the State Chamber of Commerce (NSW) (sub. D158) and BHP (sub. D117), for example, argued that any reductions in Australia's barrier protection should be contingent upon reciprocal and proportionate action by our trading partners. Similarly, Laminex (sub. 49), the Australian Aluminium Council (sub. 60) and the South Australian Government (sub. 81) considered that Australia's tariff reform should be slowed until Australia's trading partners picked up the pace of their tariff and non-tariff barrier liberalisation.

The reasons for supporting reciprocity covered at least three themes:

- as Australia had already reduced its trade barriers substantially, it was now the turn of other countries to do the same;
- reductions by Australia had exposed Australian manufacturers to foreign competition in the domestic market, yet those manufacturers did not have similar access to foreign markets; and
- irrespective of the effect on competition in the domestic market of further tariff reductions by Australia, those reductions should be used to leverage additional trade liberalisation in other countries.

The first two themes can be characterised as relating to a notion of ‘equity’ or ‘fairness’ in international trade, while the third relates to possible pecuniary benefit from bargaining — the notion of reciprocity.

Trade policy and ‘fairness’

From an economy-wide perspective, Australia benefits from tariff reductions irrespective of the actions of other countries. Likewise, Australia can gain if other countries reduce their trade barriers as this increases the size and scope of markets available to Australia (both as an importer and as well as an exporter). Many participants acknowledged that much of the benefit to Australia from past trade liberalisation had come from its own unilateral action, rather than from liberalisation by others. This conclusion is supported by analytical work (for example, McKibbin (1997) and Dee, Geisler and Watts (1996)). Nonetheless, there is a widely held view that gains are only possible with reciprocity.

The fallacy that tariff reductions are only of benefit where other countries reciprocate and reduce their tariffs was explained by Samuelson (1958):

> Some people admit that a world of free trade would be preferable to a world of tariffs. But they say that so long as other countries are so foolish or so wicked as to pass restrictive tariff legislation, there is nothing that we can do but follow suit in self-defence. Actually, however, a tariff is much like an increase in transportation costs. If other countries were foolish enough to let their roads go to ruin, would it pay us to chop holes in ours? The answer is, No. Analogously, if other countries hurt us and themselves by passing tariffs, we should not add to our own hurt by passing a tariff. (p. 678)

Moreover, as indicated in section 5.1, the view that Australia’s trade barriers are particularly low and that its exports are restricted substantially by limited access to many markets has only partial validity.

Even so, it is understandable that Australian manufacturers who face substantial competition from imports resent substantial trade barriers overseas which constrain their export potential. They regard such a situation as ‘unfair’. For instance, Kenworth Trucks asked:

> Why would we allow U.S. and European HCVs [heavy commercial vehicles] into Australia tariff free when an Australian manufactured Kenworth would be slugged up to 25% if we tried to export? (sub. D136, p. 2)

Australian governments have been conscious of such concerns in seeking reductions in those trade barriers. This, however, is only one aspect of the notion of ‘fairness’ in international trade. Australian producers, including some manufacturers, who do not receive tariff assistance regard it as ‘unfair’ that they have to bear the costs of assistance provided to others. Likewise, consumers probably would prefer greater ‘fairness’ in terms of lower costs of goods presently sold at tariff-inflated prices.

If Australia were to adopt a policy of retaining (or increasing) tariffs against specific countries with high trade barriers, it would forgo the community-wide benefits which unilateral tariff reductions can bring. Such an approach would also involve discrimination among Australia’s trading partners and could well lead to trade disputes. This is because a fundamental principle of the world trading system to which Australia is party under the WTO is that trade should be conducted without such discrimination (see box 5.2). The central issue is not whether unilateral reductions are ‘unfair’, but whether Australia, by delaying reductions:

- enhances its negotiating strength in trade negotiations; and
- if so:
  - what additional market access is it likely to ‘win’ from other countries; and
  - how the benefits of any improved access compare with the costs of delaying reductions.

Market access and reciprocity

A number of participants argued that Australia should use its remaining trade barriers as negotiating coin in trade negotiations in seeking greater access to overseas markets. For example, the NSW State Chamber of Commerce (sub. 80) argued that reducing tariffs without a negotiated *quid pro quo* would squander what limited bargaining coin Australia has to offer in pursuit of its trade liberalisation goals; a view also held by ABL (sub. D131).

As noted above, the benefits for Australia to date from trade liberalisation have come mainly from its own unilateral reduction in tariffs. This tariff reform has provided incentives for domestic producers to improve efficiency in the face of increased competition and has helped to focus Australian production on areas of activity where more efficient use is made of the country's limited resources. Nevertheless, Australia has also benefited from the growth in world trade, from unilateral liberalisation by other countries and from the opportunities arising from coordinated trade liberalisation delivered through multilateral negotiations.

However, most Australian general tariffs are now at a rate of only 5 per cent or less. Thus, the efficiency benefit to Australia from further tariff reductions will necessarily be less than in the past. Similarly, the cost to Australia of delaying further tariff reductions, in the hope that this can be used as negotiating coin in achieving greater market access in other countries, will be less than in the past. Nevertheless, the central issue remains the same. This is addressed below in terms of bilateral, commodity-based sectoral and multilateral negotiations.

Bilateral negotiations

Australia benefits significantly from the bilateral discussions and negotiations with other countries on trade matters which occur continually as part of the normal world trading environment. For example, Australia has recently made bilateral agreements, not requiring reductions in Australia's applied tariffs, with China, Philippines, India, Singapore and Saudi Arabia and announced improved market access for certain Australian goods (DFAT 2000b).

At issue in this inquiry, however, is whether reduction by Australia of its general tariffs would induce other countries, on a bilateral basis, to offer 'concessions' to Australia in addition to those which would otherwise be made.

There is scope for such profitable bilateral trade-offs. However, it is quite limited given that Australia's remaining general tariffs are low and that, under the rules of the WTO, bilateral deals cannot be made exclusive. (The only exceptions are concessions for developing countries and comprehensive customs unions or free trade arrangements, such as CER, which are consistent with GATT/WTO requirements.) This means that any tariff 'concession' made by another country for Australia would have to be extended to all WTO members and vice versa for any 'concession' made by Australia. As observed by the Australian APEC Study Centre:

> Australia has little reason to assume that it can secure much in the bilateral processes. It has little bilateral political leverage and efforts at bilateral leverage rarely result in significant reductions of trade barriers. (sub. 48, p. 7)

Under any bilateral trade-offs, what would be offered by Australia is piecemeal tariff reductions, with all their advantages and disadvantages — including political difficulties of removing assistance, provided selectively to local producers, on the basis of requests from trading partners. What would be sought by Australia in return is an expansion in an overseas market, open to all comers, for selected products of other Australian producers.

In principle, such trade-offs could be assured of improving community welfare only in circumstances where any additional exports were from unassisted production, where lower trade barriers reduced prices and increased the range of goods available to Australians and where any displaced production resources were taken up by unassisted industries.

While bilateral trade-offs could make a useful contribution in such circumstances, they would not be a substitute for more broad-based measures to improve community welfare such as through unilateral action to reduce the tariffs under reference, or more wide-ranging multilateral negotiations.

The practical difficulties of removing assistance selectively on the basis of requests from trading partners, such as which countries should be chosen and which products should be traded off, raise the possibility of confining some of the trade-off selection problems to sectors through commodity-based negotiations.

Commodity-based negotiations

Some participants argued that general tariffs of products of interest to them should not be reduced as those products were included in multilateral commodity-based, or sectoral, trade liberalisation negotiations. For example, Orica Australia considered that:

> it would be inappropriate to recommend further tariff reductions until there was firm commitment from all CTHA [Chemical Tariff Harmonisation Agreement] non-signatories to bind their tariffs to a phasing program as soon as possible. (sub. 43, p. 2)

While some sectoral trade agreements (eg the WTO Information Technology Agreement) appear to be beneficial, a sectoral approach is not viewed by DFAT as the preferred means of seeking trade liberalisation:

> The common thread running through all trade reform efforts is that gains from trade negotiations will tend to be greater the larger the number of countries involved, and the broader the product coverage of the negotiations. In practice it is also easier for governments to implement trade liberalisation if more governments, and more industries in other countries, are engaging in liberalisation. … Sectoral agreements offer a means of achieving additional liberalisation, but they carry the risk of limiting the sorts of productive trade-offs that are possible in a larger negotiation. The broader the array of sectors or issues subject to negotiation, the greater the potential for securing agreements which all parties can determine as in their interests. (DFAT 1999)

As with bilateral deals, commodity-specific negotiations may result in an unintended misallocation of resources due to the 'piecemeal' nature of the resulting tariff reductions. An example of these efficiency effects is given by the proposal for an Early Voluntary Sectoral Liberalisation package developed in APEC. Although no agreement has been reached to implement this proposal, the Australian APEC Study Centre noted:

> It [the package] did not cover all members of APEC and covered some sectors and a few products. Modeling of the effect of the package by the Productivity Commission, as well as agencies in New Zealand and Taiwan demonstrated that the economic welfare effect of the package for those three countries was negative. (sub. 48, p. 5)

Australia's limited significance in world trade — for example, in the cases of chemicals and steel — suggests that Australia would have little chance of using reductions in general tariffs to leverage additional concessions from other countries in respect of those commodities. Thus, Australia would have little to lose from comprehensive early unilateral tariff reductions involving these products. The existing CTHA provides an example. Under the Agreement, to which there were 17 signatory countries as at 1 January 1999, countries have undertaken to reduce the upper tariff rate placed on chemicals to 6.5 per cent by 2004 (PACIA sub. 40, p. 2). As Australia's chemical tariffs have been at a maximum of 5 per cent since 1996, there was no need to offer tariff reductions in order to see tariffs lowered by other countries.

Multilateral negotiations

As with bilateral or commodity-based negotiations, Australia's negotiating 'clout' in multilateral negotiations is likely to be limited as a result of its small share of world trade. As the Chamber of Commerce and Industry Western Australia commented:

> it is unrealistic to expect a small trading nation with relatively low residual tariffs to be able to exercise any significant leverage by offering to reduce its tariffs. (sub. D133, p. 1)

Importantly, multilateral tariff negotiations are conducted usually on the basis of *bound* rates. In Australia's case, in contrast to that of most other OECD countries, most of these are considerably higher than the duties actually *applied*. Would further unilateral reductions in Australia's applied tariffs under reference increase its bargaining power in terms of bound tariffs? Or would such reductions reduce Australia's ability to offer meaningful trade-offs?

DFAT expressed the view that early reductions in Australia's applied tariffs could *strengthen* Australia's negotiating position rather than weaken it:

> For example, reducing our applied tariffs might make it possible for Australia to go further in supporting across the board (or formula) reductions in bound rates than otherwise — in the knowledge that this would not require any further changes to applied rates. (sub. 65, p. 29)

Others disagreed, however. For instance, the NSW Minister for Small Business contended that:

> Australia's share of world trade is relatively small and our ability to influence global trade outcomes through a magnanimous gesture on tariff reduction would be improbable. (sub. D143, p. 3)

Some participants drew on the recent settlement of the trade dispute with the United States regarding the leather producer, Howe and Company Pty Ltd, to support their case for maintaining applied tariffs as bargaining coin in trade negotiations. The AIG, for example, stated that:

> A key part of the settlement with the United States is an agreement to remove tariffs on a range of products. Had the Commission's draft recommendation [to remove the 5 per cent tariffs] already been accepted we would have been left with a weakened bargaining position, to the potential detriment of Australian industry. (sub. D122, p. 2)

However, the details of that settlement show that, even in this bilateral negotiation, the major bargaining coin was the prospect of reducing to zero for twelve years Australia's *bound* as well as applied rates (see box 5.4). As the effective 'applied' rates were already zero for most of the items, a temporary lowering of bound rates was central to the outcome. The agreement with the United States involves virtually no cost to other Australian industries.

Unilateral reductions in general tariffs ahead of Australia's APEC commitments could provide some 'moral leadership' in multilateral trade forums. DFAT and the Australian APEC Study Centre considered that a decision to eliminate all general tariffs ahead of the Bogor commitments could significantly elevate Australia's role in WTO and APEC negotiations in pursuit of freer world trade. This could help to reduce foreign barriers to Australian exports, including those from industries in rural and regional areas. Similarly, Professor Ross Garnaut had no doubt that:

> … Australia … would be more likely to influence the decisions of others favourably by demonstrating its confidence that earlier Australian trade liberalisation had been in the national interest, by continuing the process of unilateral liberalisation. (sub. D164, p.2)

Professor Garnaut (2000) was also of the view that:

> The completion of the removal of protection … [would allow] … us to commit to trade liberalisation in the context of current discussions on a link between the ASEAN Free Trade Area and the Australia New Zealand Closer Economic Relations Agreement without introducing discrimination against other trading partners. (p. 11)

Box 5.4 A negotiated response to the Howe leather dispute with the USA

On 21 June 2000, the Australian Government announced arrangements to resolve the trade dispute with the US regarding export subsidies provided by the Australian Government to the Australian automotive leather manufacturer, Howe and Company Pty Ltd (Vaile 2000c). Among those arrangements was an agreement by Australia to remove tariffs on a range of products covered by 30 tariff items, to apply from 1 July 2000.

Imports of these items in 1999 accounted for about $600 million from all sources. Nominal tariffs on all items were 5 per cent. However, the majority of these imports enter under tariff concession arrangements, which resulted in duties on them being only about $1.6 million. The average actual applied tariffs were thus negligible at about 0.25 per cent, and would be commensurately negligible in terms of their bargaining worth.

The bound rates for these items, however, were significantly higher. Two items were bound at a 5 per cent rate, ten at 10 per cent, sixteen at 15 per cent, one at 13 per cent and one at 23 per cent. All items have moved to a bound rate (and thus an applied rate) of Free under the agreement.

Source: PC estimates based on ABS trade data; Annex A of the Automotive Leather Subsidies: Understanding between the Government of the United States of America and the Government of Australia.

In summary, retention of existing general tariffs of 5 per cent is unlikely to enhance Australia's negotiating strength in trade negotiations. Australia's share of total world trade is very small, thus limiting its ability to use remaining tariffs in bilateral, commodity-based or multilateral negotiations to leverage greater market access. Consequently, arguments for reciprocity do not represent an offset to the benefits from tariff reductions by Australia on a unilateral basis.

6 Tariff concession arrangements

The terms of reference ask the Commission to take into account the interaction of any changes to the general tariff with various tariff concession arrangements. In addition, the Commission has been asked to consider the appropriateness of the Tariff Concession System (TCS) and Project By-Law arrangements.

In general, these concession arrangements either:

- assist some businesses and consumers by allowing the importation of particular goods at concessional rates of duty (which involved some $400 million in total duty forgone in 1998-99); or
- assist exporters by allowing the deferral, removal or refund of duty on imported goods subsequently exported or incorporated into exports.

This chapter briefly summarises relevant tariff concession arrangements, describing their purposes, administrative procedures, use, and administrative and compliance costs. Taking participants' comments into account, the arrangements are evaluated in terms of their positive and negative assistance effects and the administrative and compliance costs they impose. As well, the implications of general tariff reductions for these arrangements are considered.

The tariff concessions covered in some detail in this chapter are the TCS, Project By-Laws and some other policy by-laws of concern to participants, Manufacture in Bond (MiB) and some export concession arrangements.

Appendix C provides greater detail about these arrangements. It also includes a more expansive listing of participants' comments about the justification for concession arrangements, their concerns and their suggestions for change.

6.1 The Tariff Concession System

The TCS is a widely available concessional arrangement that provides free or concessional entry to imports which do not have locally produced substitutes. It provides for:

- duty free entry for goods specifically listed as consumption goods (see item 50A of Schedule 4 of the Customs Tariff); and

- a 3 per cent duty for all other eligible goods, ie business inputs (see item 50 of the Schedule).

The current TCS was introduced in 1992, replacing the Commercial Tariff Concession Scheme (CTCS) which had been in place since 1983. Like its predecessor, the TCS originally allowed all eligible goods to be imported duty free. The 3 per cent duty for business inputs was introduced in 1996 to help 'improve the Budget situation' (Moore 1996).

The TCS is administered by the Australian Customs Service (Customs). This involves assessing applications made by importers for Tariff Concession Orders (TCOs), granting or denying TCOs and administering the revocation process for TCOs. Customs also undertakes internal reviews as part of an appeals process on the granting or revocation of TCOs. External appeals are dealt with by the Administrative Appeals Tribunal.

The sole criterion for granting a TCO is that substitutable goods are not produced in Australia at the time the TCO application is lodged. Substitutable goods are Australian-made goods which have a use corresponding to the use of the imported goods (Customs Tariff Concession System Factsheet). The applicant is required to provide details and results of the inquiries undertaken to establish that there are no substitutable goods produced in Australia. This may involve drawing on the resources of the Industrial Supplies Office (ISO) network, which can provide information on Australian industry capability.

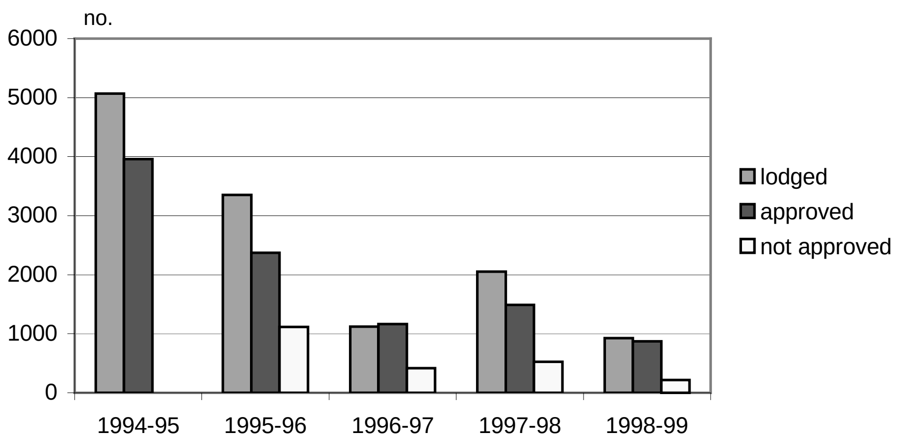
All applications for TCOs are published in the Commonwealth of Australia Tariff Concessions Gazette. This allows domestic manufacturers the opportunity to object before a TCO is granted. Appeals against the granting of a TCO must be made within 50 days after the application is gazetted. Customs then considers the application against the substitutable goods criterion and makes a decision within 150 days of gazettal. If granted, the TCO comes into effect from the date the application was received by Customs. Any goods eligible for a TCO imported in the period between the lodgement of the application and the granting of the TCO are eligible for a refund of the relevant duty. As the TCO pertains to a specific good and not the applicant, once the TCO is granted other importers are able to use it to import the eligible goods on a concessional basis.

Certain classes of goods such as food, clothing, footwear and passenger motor vehicles listed under the Excluded Goods Schedule of the Customs Regulations are ineligible for TCOs.

Use of the TCS

The proportion of imports covered by TCOs has declined in recent years. In 1998-99, nearly 11 per cent of all imports were covered by TCOs, compared with around 18 per cent in 1995-96. The number of tariff concession applications lodged has also declined over recent years. In 1994-95, just over 5000 applications were lodged; by 1998-99 applications had declined to around 1000 (see figure 6.1).

Figure 6.1 **Tariff concession applications, 1994-95[a] to 1998-99**



[a] Data for tariff concession applications not approved in 1994-95 are not available.

Source: Australian Customs Service (1997, 1999).

As at 17 July 2000, there were 10 708 TCOs in total. Of these, around 16 per cent were for consumer goods that enter duty free, while the majority were for business inputs subject to the 3 per cent concessional tariff.

The decline in the number of TCO applications, coupled with reductions in general tariffs and the introduction of the 3 per cent duty, has been reflected in reductions in the revenue forgone through the TCS. In 1996-97, around $455 million in revenue was forgone, but that figure had declined to around $370 million by 1998-99 (Customs 1999). However, the revenue forgone is small relative to the total customs duty and Commonwealth revenue collected. In 1998-99, the revenue forgone through the TCS was less than 13 per cent of total customs duty and 0.2 per cent of the total revenue collected by the Commonwealth.

More detailed information shows that in 1998-99, the value of imports of goods under reference (on a cif basis) under the TCS was $8937 million and the duty collected on these imports amounted to $191 million. If all these goods had been dutiable at 5 per cent (on an fob basis), then the total duty collected would have been around $425 million. This suggests that the duty forgone for goods under reference in 1998-99 was $234 million. This is lower than the total for all goods mainly because reductions in general tariffs since 1998-99 have reduced the scope of the TCS.

Administrative and compliance costs

In addition to the customs revenue forgone by the Commonwealth Government, costs are incurred by Customs in administering the system and by the users in complying with TCO procedures. (In this report, user costs are referred to as 'compliance' costs. Costs incurred by Customs in ensuring that users comply properly with its requirements are considered to be part of its administrative costs.)

The current annual cost of administering the TCS by Customs is estimated to be around $2.25 million. This includes salaries, administrative expenses and an allocation for corporate overheads (information supplied by Customs).

Estimation of the costs incurred by the users of the TCS is more difficult. Some users considered that the compliance costs could outweigh the benefits to users from tariff reductions obtained with TCOs. For example, Mr Colin Davey, a tariff consultant, said that unless a firm was importing goods worth at least $100 000 the costs of using the system exceeded the value of the tariff concession:

> Naturally anything short of $100 000 in value which would give you a couple of thousand dollars rebate, is not even worth looking at. … by the time you research and do what is required under the system, unless you're getting back in excess of $2000 you're not going to get much for your return and you run the risk that you spend several thousand dollars and achieve nothing because the tariff concession is refused. So it's got to be worth the effort. (trans., pp 136–7)

Similarly, the Brushware Manufacturers' Association believed the costs of the system were greater than the benefits it provided:

> Since so little relief is afforded by the T.C.Os, our industry will request their revocation. This would save Customs work and money. It would also save manufacturers time and expense scanning proposals and challenging those seen to be unsupportable. … It is our hope that other sectors of industry will wish to be treated similarly, thereby reinforcing a move towards winding down this cumbersome system. (sub. 37, p. 5)

The Chamber of Commerce and Industry Western Australia also commented on high administrative and compliance costs:

> the relatively high administrative costs associated with relatively modest benefits under preferential and concessional tariff arrrangements … mean that the net benefits are small, and many businesses do not even bother to apply for concessions. (sub. D133, p. 3)

The available information suggests that around 90 per cent of applications are prepared by customs brokers and agents, although there is no necessity to use their services (see Customs, sub. 93, attachment A). Assuming a charge on average of between $3000 and $4500 to prepare an application (including the cost of determining the existence of domestic substitutes and verifying this to the ACS) then, given that there were around 1000 applications in 1998-99, users of the system pay between $3 million and $4.5 million per year to brokers and agents. As well, there are costs associated with monitoring the gazette, lodging objections and appeals and in the use of ISO services.

The Commission is not able to give a firm estimate of total administrative and compliance costs. However, based on the available information, the combined cost to government and industry is at least $6 million per annum.

6.2 Evaluating the TCS

The current TCS is the most recent in a number of schemes which have sought to reduce the taxing effect of tariffs on imported goods when there is no domestic production to benefit from protection. These schemes, including the TCS, have been subject to a number of reviews since 1980. A summary of those reviews is set out in box 6.1.

The current scheme differs from the previous schemes, including the TCS prior to 1996, in that a distinction is made between consumer goods and business inputs. This distinction is made on the basis of a list of tariff headings included in Item 50A. Under the TCS, consumer goods are afforded duty free entry while the balance, business inputs, are levied with a 3 per cent tariff.

As noted in appendix C, the increase in the concessional rate for business inputs from Free to 3 per cent was the major concern of participants about the TCS. The increase was seen as adding to costs and reducing the competitiveness of Australian manufacturers in both domestic and overseas markets. For example, the Australian Industry Group considered:

> The 3% tariff (tax) imposed on industry under the TCS should be abolished. It is bad policy when assessed against any measurement to improve the international competitiveness of Australian industry. (sub. 63, p. 11)

It also creates circumstances where local manufacturers pay a 3 per cent tariff on their inputs, while imports competing with the manufactured goods which use those inputs enter duty free. For example, Philips Electronics Australia noted that it had to pay duty on spare parts for equipment which itself could be imported free of duty:

Box 6.1 Previous reviews of tariff concession arrangements

There have been three reviews of tariff concession arrangements since the early 1980s — the IAC (1982b) report on the Commercial By-law System, the IC (1991b) report on the Commercial Tariff Concession and By-Law System and a Customs (1995) evaluation of the Tariff Concession System. Their findings and recommendations are summarised below.

The Commercial By-Law System

- the system had extensive support from a wide range of sectors, with many activities dependent on concessional entry for their inputs;
- the by-law system made for relatively fast decision-making on reductions in assistance in comparison with tariffs referred to the IAC for review;
- there were concerns that any change in assistance levels either through removal of the by-laws or changes in tariff levels would change relative levels of assistance which could alter prices, market share and the allocation of resources; and
- the Commission recommended that the system should be maintained with a number of modifications to improve the efficiency of the system.

The Commercial Tariff Concession and By-Law System

- as there were economy-wide benefits in retaining existing concessions, the CTCS should continue, with improvements in the operation of the system;
- the lowering of tariffs since the early 1980s had removed the capacity for concessions to widen disparities in assistance and misallocate resources; and
- as tariffs declined, the costs of the system will increase relative to the benefits and the value of continuing with the concessions will need to be assessed.

The Tariff Concession System

- the annual cost to Customs is about $3 million, so the total net cost to the economy could be an order of magnitude higher, about $30 million, or between $10 million and $50 million, depending on its overall design and efficiency; and
- if retained, the TCS should be modified, including removing the market test for the core criteria and shifting the onus of proof to the applicant to identify the possible local manufacturers of substitutes.

Source: IAC (1982b), IC (1991b), Customs (1995).

> Most of these [business input] concessions cover parts that are imported for repair of current equipment, for which there is no local manufacture. This brings up the anomaly of importing a complete product duty free, but having to pay duty on parts to repair that machine. (sub. 14, p. 1)

In commenting on bowls manufacturer Henselite’s submission made at the January 2000 public hearings, Mr Barry Johnston noted that:

> Henselite is … paying a premium price [under the TCS] for raw materials which only benefits Henselite’s overseas competitors who pay no duty because they source locally in the UK. (sub. D98, p. 3)

According to the Australian Customs and Brokers Association, Australia was almost unique in penalising producers in this way:

> As a consequence, this unorthodox form of business taxation acts to make fully imported consumption goods more competitive than locally produced goods which require business inputs. This leaves Australia as one of the few, if not perhaps the only country in the world, to apply to its manufacturing industry, a form of taxation which has the impact of encouraging imports by making such goods more competitive as against locally produced goods! (sub. 50, pp. 3–4)

The submission on behalf of New Holland Australia referred to an anomaly in the tariff treatment of balers resulting from the 3 per cent revenue duty:

> … big-ticket items [for farmers] such as BALERS are treated in 2 different ways. Round balers are duty free at the substantive tariff item level, whereas square balers are subjected to the 3% revenue duty. Even though both are NOT manufactured in Australia. Inequities such as this do nothing other than create unnecessary distortions in the marketplace. (sub. D155, p. 3)

Some participants contended that, as the budget is now in surplus, the rationale for its introduction no longer exists. For example, the ACCI (1999) said:

> Amendments made to the Tariff Concession Scheme (TCS) in 1996 were explained as a way of business sharing in the burden of the deficit reduction process. The changes resulted in a three per cent tariff on many business inputs as a means to raise revenue. With the budget now well and truly back into surplus, the Government needs to reverse this highly distortionary and anti-competitive revenue measure. (p. 1)

Box 6.2 illustrates participants’ concerns about the 3 per cent business input duty, using stainless steel as an example.

Other concerns of participants related to detailed matters of procedure and administration. For example, one participant said that the criteria used to determine substitutability should be widened to include such factors as price, quality, deliverability and safety. Another considered that the TCS should be based on a ‘market competitive’ goods test rather than the ‘corresponding use’ goods test. In addition, they considered that the criterion that allowed a manufacturer with the ‘potential’ capability to manufacture needed to be changed. Concerns were also expressed about the lack of notification and timeframe for revoking of existing concessions. These concerns are listed in greater detail in appendix C.

Box 6.2 **Participants' views: the case of stainless steel**

Background: Stainless steel flat products are semi-fabricated forms of stainless steel that are used in the production of finished goods in a range of industries including the wine industry, food processing industry, dairy industry and automotive industry. About 90 000 tonnes of stainless steel flat products are used in production in Australia each year (sub. 30).

Prior to May 1997, stainless steel was manufactured in Australia by BHP and a tariff of 5 per cent applied to imports. The closure of BHP's stainless steel cold rolling mill at Port Kembla, coupled with the introduction of the 3 per cent duty on business inputs under the TCS, has meant that stainless steel is now imported, but with a tariff of 3 per cent.

Participants' comments: A number of participants commented on the negative effect of the tariff on the industry. The Australian Steel Association said:

> For any tariff measure to have legitimacy, it must by definition, assist local industry. The 3 per cent has the opposite, and most adverse effect on local industry. Stainless steel imports are a classic illustration. (sub. 18, p. 3)

Austral Wright Metals (sub. 13, pp. 1-2) reported that the 3 per cent tariff increases the cost of stainless steel by about $158 per tonne, or $14 million annually, and that this cost is subsequently passed on to the end consumer.

The Winemakers Federation of Australia referred to the impact on industry costs:

> It probably costs our industry 6 or 7 hundred thousand dollars a year and that, we forecast, will increase to probably $1 million next year … Now there's no domestic producer of stainless steel that I know of, particularly of the tank material, so it seems an ideal tariff that could be a significant help to our industry if we could remove it. (trans., p. 111)

Email Metals Distribution observed the effect of the tariff on competitiveness:

> … stainless steel flat products are not dutiable when imported into New Zealand. Because the stainless raw material can, and often does, represent a high cost component in the fabrication process, the application of the 3 per cent tariff in Australia has the effect of disadvantaging Australian steel fabricators when competing with their New Zealand counterparts. New Zealand manufacturers do not pay duty on the steel or product exported to Australia. (sub. 9, p. 3)

Moreover, WMC Resources stated that:

> Removal of the tariff on stainless steel flat products will result in more competitively priced stainless steel products. Such an increase in demand for stainless steel will ultimately be of benefit for nickel producing countries such as Australia. (sub. 42, p. 1)

Further, the Nickel Development Institute suggested that removal of the tariff would improve efficiency and have environmental benefit.

> Stainless steels are renowned for their long service life because of their ability to resist corrosion and to operate at high temperatures … Furthermore they are environmentally friendly, being 100 per cent recyclable. … Making stainless steel more accessible and attractive will assist in bringing these same benefits to Australia. (sub. 36, p. 1)

Assistance effects

In considering the assistance effects of the TCS, consumer goods and business inputs should be examined separately.

Consumer goods

Where there is no local production of a particular consumption good or of its substitutes, a tariff merely serves as a tax on consumption — the tariff has no effect on the nature and extent of local production. In this situation, the TCS arrangements are likely to remove the 'deadweight loss' associated with tariffs on consumer goods.

Business inputs

In contrast to consumer goods, the duty relief provided by the TCS for business inputs can affect the nature and extent of protection afforded to local manufacture, even though there is no local production of those business inputs or of substitute goods. This is because a TCO on business inputs enables producers to obtain inputs at lower prices than would otherwise be the case. In turn, this increases the levels of effective assistance on outputs (see box 2.2). This conclusion can be illustrated by reference to table 6.1 which shows the assistance effects of granting a concessional rate of 3 per cent or Free on business inputs when a general tariff of 5 per cent would otherwise apply to those inputs.

Table 6.1 **Impact of a tariff concession on effective rates of assistance**

	Assembly type manufacturing operation (value added of 25 per cent)				Typical manufacturing operation (value added of 35 per cent)				Elaborately transformed manufacturing operation (value added of 50 per cent)			
	Input nominal rates											
		5→	3→	→0		5→	→3	→0		5→	→3	→0
Output nominal rates	5	5	11	20	5	5	9	14	5	5	7	10
	0	-15	-9	0	0	-9	-6	0	0	-5	-3	0

To simplify the argument, the table ignores the distinction between tariff rates, expressed in fob terms, and nominal rates, expressed in ldf terms. It also assumes that the duty concession applies to all inputs. These simplifications exaggerate the assistance effects, but do not affect their direction.

Introducing concessional rates increases effective rates of assistance in every case (see the shaded area in table 6.1), with the largest increases for assembly-type operations. In comparison with the current manufacturing average effective rate of about 5 per cent on business inputs, a concessional rate of 3 per cent or Free:

- has the negative effect for the economy of increasing effective rates on outputs to levels above 5 per cent for those outputs for which a nominal tariff rate of 5 per cent would apply; and
- has the positive effect for the economy of moving the negative effective rates on outputs towards zero for those outputs for which a Free nominal tariff rate would apply.

The overall effect on assistance levels and structures of a concessional rate of tariff on business inputs thus depends on a number of factors including the rate of concessional tariff, the proportion of inputs to which it applies, the rate of tariff on outputs and the nature of the manufacturing activity itself. The table illustrates that the positive and negative effects are stronger the lower the proportion which the manufacturing activity itself contributes to the value of output (ie the higher the proportion of inputs).

In an attempt to weigh up these positive and negative assistance effects of the TCS, the Commission has analysed the effects of reducing the concessional rate on business inputs from 3 per cent to Free, while maintaining general rates at 5 per cent. The reduction is estimated to increase real GDP slightly, with the gain for the mining sector more than offsetting a relatively small loss for manufacturing. The gain to mining arises because machinery and equipment for use in that sector constitute a large proportion of concessional imports. The lower price for those inputs facilitates extra mining activity. For manufacturing, the small negative effect reflects, in part, the increased competition for resources by the mining sector as well as a less efficient allocation of resources within the manufacturing sector itself.

Administrative and compliance costs

As noted above, the administrative and compliance costs of the TCS are of the order of at least $6 million per annum. As these costs are not included in the above analysis, the question arises as to their magnitude relative to the net benefit of the TCS arrangements. The Commission estimates that, while general tariffs remain at 5 per cent, the benefit of a concessional rate for business inputs of 3 per cent or Free exceeds those administrative and compliance costs.

6.3 Project and other policy by-laws

Essentially, industry policy by-laws (those under the Project By-Law Scheme and the former Policy By-Law Scheme) are intended to provide concessional tariff rates where this contributes to industry policy objectives. Each application is considered separately on its merits to take into account the effect on local producers of the by-law. However, with the introduction of the 3 per cent concessional duty for business inputs under the TCS, policy and project by-laws allow some goods which would be eligible for entry under the TCS to receive a lower concessional rate of duty.

The Policy By-Law (PBL) Scheme, which ceased on 1 August 1998, provided tariff concessions under items 43, 45, 46, 47, 52, 55, 56, 57 and 60 of Schedule 4 of the Customs Tariff (sub. 93, attachment B). Three of these items, ie 45, 46 and 56, have been known collectively as the Project By-Law Scheme from 1 August 1998. The remaining items no longer form part of any specific scheme, while item 55 was repealed in 1999. The broad coverage of these items is as follows (more detail is given in appendix C):

- items 43 and 52 provide concessional entry, at the rate applicable to the whole good, for split consignments of complete equipment;
- item 47 allows for the entry of capital equipment at a concessional rate of 3 per cent where tariff concession orders (under the former CTCS) exclude certain components which could be made in Australia;
- item 57 allows duty free entry for a range of raw materials and intermediate goods that offer a substantial and demonstrable performance advantage over substitutable goods produced in Australia;
- item 60 is similarly free of duty for metal products and goods used in food packaging that offer a substantial and demonstrable performance advantage over similar material currently made in Australia; and
- of the project by-laws, for which the concessional duty is free, item 45 covers equipment for use in mining and resource processing projects, item 46 equipment for use in the agriculture, food processing and food packaging projects, and item 56 covers 'state of the art' capital equipment.

Other industry policy by-laws (excluding those relating to TCF and PMV) which allow duty free entry are mentioned briefly in box 6.3.

Each by-law item is subject to a number of conditions that restrict its scope. In general, the goods to be imported must satisfy the terms of the relevant by-law item and the granting of the concession must be consistent with prevailing government policy. In addition, there are also specific conditions. For example:

Box 6.3 Some other industry policy by-laws

Item 13: Applies to certain goods that are used in connection with an Australian Industry Involvement Program, approved by the Commonwealth, under existing (but not future) Department of Defence contracts.

Item 22: Assists the petroleum industry through the entry of certain goods imported for use directly in connection with the exploration for, and discovery of, oil and gas deposits and the pre-production development of wells on those sites provided that substitutable goods are not produced in Australia. The administration (but not the policy) of this item is currently under review by Customs.

Item 29: This applies to prototypes, and has had minimal usage.

Item 30: Applies to robots and their parts and accessories.

Item 31: Applies to a range of goods (excluding textiles and goods made of textiles) for use in the manufacture, repair and maintenance of aircraft.

Item 36: Covers some chemical products.

Item 38: Applies to a range of plastics.

Items 39A, 39B, 39C: Cover coated paper used in high quality magazines; clay coated paperboard for use in the manufacture of aseptic liquid packaging; and paper and paperboard for use in the manufacture of flip-top cigarette packaging, respectively.

Item 42: Applies to parts of vessels and materials used in the construction, modification and repair of vessels exceeding 150 gross construction tons.

Item 51: Applies to aluminised steel for use in the manufacture of automotive mufflers and exhaust components.

Item 65: Applies to inputs to the manufacture of information industries equipment where those inputs were covered by a Commercial Tariff Concession Order or a TCO.

Item 66: Applies to aluminium sheet used in the manufacture of aluminium cans.

Since 1991, requests for new concessions under items 36, 38, 39A, 39B and 39C have been dealt with under item 57, which covers a range of inputs to manufacture including chemicals, plastics, paper and paperboard.

Source: Based on Customs, sub. 93, appendix 1.

- requests for items 56, 57 and 60 must include an independent technical assessment quantifying the perceived performance advantage of the imported goods over locally produced goods;
- with items 43 and 52, it may be necessary to demonstrate that there are logical and economically sound reasons to import complete equipment in separate consignments;
- a $10 million project threshold applies for items 45, 46 and 56; and

- applications must be made before the equipment is imported.

Applicants may also need to demonstrate whether or not there are Australian manufacturers of similar goods and to specify the efforts taken to maximise opportunities for any such manufacturers to produce the goods in question. This can involve the ISO network in identifying potential Australian suppliers and their capabilities.

From 15 April 1999, an application for items 57 or 60 and the Project By-Laws needs to be made to AusIndustry, part of the Commonwealth Department of Industry, Science and Resources. Requests for concessional entry for other policy by-law items must continue to be made to Customs. Responsibility for entry requirements and associated administration and compliance is retained by Customs.

Use of by-laws

The revenue forgone from project and other policy by-laws has declined in recent years (see table 6.2). No applications for items 47 and 52 have been lodged over the past three years and only a limited number for item 43. The workload for items 45 and 46 has also declined considerably over the period and use of item 56 was negligible in 1999-00 (table 6.3). (Appendix C includes information about changes in the criteria for these by-laws that may have contributed to the general decline in use.)

Table 6.2 **Duty forgone under selected by-laws, 1995-96 to 1998-99**
$ million

Concessional item	*1995-96*	*1996-97*	*1997-98*	*1998-99*
Policy by-laws[a]				
Item 43	14.0	5.8	2.0	0.2
Item 47	26.4	3.2	1.4	1.5
Item 52	0.2	0	0	0[b]
Item 57	9.6	5.9	7.5	7.0
Project by-laws				
Item 45	42.5	9.3	16.8	10.7
Item 46	2.0	1.3	1.5	2.1
Item 56	5.1	3.9	4.8	1.0
Total[c]	**99.7**	**29.2**	**34.1**	**22.5**

a Only one determination has been made for item 60 over the period. The duty forgone amounted to approximately $36 000 in 1996-97. **b** Expenditure was $2000 in 1998-99. **c** Totals may not add due to rounding.

Source: Australian Customs Service (1999) and information supplied by the Department of Industry, Science and Resources.

Table 6.3 **Workload data for project by-laws, 1995-96 to 1999-00**

Number of applications lodged

	1995-96[a]	*1996-97*	*1997-98*	*1998-99*	*1999-00*[b]
Project advice					
Item 45	3	41	37	11	8
Item 46	1	13	7	5	2
Item 56	1	9	8	6	2
Goods request					
Item 45		88	233	170	45
Item 46	1	12	24	16	11
Item 56		12	13	17	1

a Accurate/complete data for 1995-96 are not available as the reporting database became operational in 1996-97. **b** Data are for period to 9 March 2000.

Source: DISR, sub. 94, attachment 4.

Participants' views

In general, participants favoured these by-laws on the grounds that the reduced costs improve the competitiveness of Australian industry, especially in respect of major capital projects (see box 6.4).

Some participants considered that the criteria for the by-laws had been tightened and interpreted too narrowly in recent years. They called for a more liberal approach to be taken — for example, Digital Audio Technologies Australia requested that 'the original principles underlying the [by-law] system be reintroduced and given proper effect according to the beneficial intent' (sub. 62, p. 15).

A number of ways of increasing the practical scope of the by-laws were suggested, including: reducing or abolishing the $10 million threshold for project by-laws; interpreting 'project' and 'capital equipment' more broadly; and allowing split consignments to be shipped from various ports (see box 6.5). More detailed comments relating to administration are covered in appendix C.

Administrative and compliance costs

AusIndustry estimated that its administrative costs for the Project By-Law Scheme and item 57 will be around $470 000 for 1999-00. This includes salaries, administrative expenses and overheads. While it also has responsibility for item 60, it has not received an application for this item since the program was transferred on15 April 1999. Customs has advised that the cost of administering industry policy items for which it has responsibility is estimated at $438 000 in 1999. This includes a one-off cost of around $98 000 to finalise a number of outstanding project by-law matters (sub. 93, attachment B, p. 3).

Box 6.4 **Value of project and other policy by-laws**

Mayne Logistics E A Rocke said that:

> … there are many commercial reasons why the items 45/46 and 56 (State of the Art equipment) Policy By-Laws should be retained.
>
> … There are a number of major projects in which I have been involved in recent years where the import duty savings achieved under the Policy By-Law Scheme have been a significant factor in those projects being established in Australia. (sub 39, p. 3)

Further, it indicated that should the 3 per cent revenue duty under the TCS be reduced to zero, there would still be value in retaining these by-laws (sub, D162, p. 1).

Orica referred to the benefits that apply to importers utilising the by-law system. It said:

> The removal of the By-Law System would significantly disadvantage new investment in Australian industry, as well as impacting the competitiveness of Australian exports. (sub. 43, p.4)

Similarly, Murray Goulburn Cooperative, P W Hannah and Associates (International) Pty Ltd and Bonlac Foods Limited saw value in the schemes and expressed the view that the Project and Policy By-Law Schemes should be retained. Bonlac Foods stated:

> Government's costs to administer the Project & Policy By-Law Schemes are not high when compared to the benefit that those schemes deliver through increasing the international competitiveness of Australian industries. (sub. 58, p. 7)

The Australian Aluminium Council stated that 'in the case of Project By Law arrangements, these are very important to allow import of major capital equipment, often worth many millions of dollars' (sub. 60, p. 6).

Tolliday Customs Agency Pty Ltd expressed support for retention of the By-Law System (sub. 2, p. 1). Similarly, Digital Audio Technologies Australia requested that 'the Commission recommend retention of the PBL system as an instrument of industry-specific assistance policy' (sub. 62, p. 15).

The Australian Chamber of Commerce and Industry supported the continuation of the policy by-laws and the Project By-Law Scheme until the general rates are reduced to Free. They considered that the policy by-laws 'are still relevant to the manufacturing sector as they reduce costs to industry and they encourage and enhance investment in Australia.' … In addition, 'industry believes that this scheme [Project By-Law Scheme] has meant some major projects have occurred which otherwise may not have …' (sub. D153, p. 2).

Sonoco Australia Pty Ltd said the company and its customers benefit from concessional entry of specialised imported high strength paperboard through the use of item 57 (sub. D154, p. 2).

Box 6.5 **Examples of participants' suggestions for changes to by-laws**

$10 million threshold for Project By-law Scheme

Laminex Industries (sub. 49, p. 22 and D138, p. 6) and Murray Goulburn Co-op. (sub. 64, p. 11) supported reduction of the $10 million threshold to $5 million. Michael Haywood Trade Consultants (sub. 32, p. 4) and MSAS Global Logistics (sub.17, p. 4) went further in recommending that the $10 million benchmark be abolished. Similarly, the South Australian Government supported this stance. It said:

> The benchmark unnecessarily discriminates against and harms small and medium-sized firms, who are subsequently forced to pay higher costs than large firms for the same product. (sub. 81, p. 11)

By-law definitions

The Australian Petroleum Production and Exploration Association Limited indicated that, for many projects within the oil and gas industry, item 45 does not always cover the totality of a project — for example, the interconnecting pipeline for an offshore production facility, which they regard as an integral component of a wider project (sub. 38, p. 8).

The Australian Gas Light Company stated that the interpretation of Item 45 provisions by the administering bureaucracy had become so narrow as to exclude many projects. Accordingly, it said that they should 'be returned to their original intent by being applied to any mining or mineral processing or oil and gas project that produces or processes such goods or transports them by conveyor or pipeline' (sub. D139, p. 3).

Digital Audio Technologies Australia said that, in regard to item 45, the repeal of the wording of the by-law to read 'capital equipment' instead of 'goods' meant that 'parts of capital equipment cannot be imported duty free unless they also happen (fortuitously) to be capable of identification as "capital equipment"' (sub. 62, p. 21).

Mayne Logistics E A Rocke considered that Customs placed an unduly restrictive interpretation on the term 'capital equipment' (sub. 39, p. 5).

Split consignment provisions

Laminex industries had the view that the 'delivery of current policy on importations of large single functional capital equipment is detrimental to industry and needs to be revised' (sub. 49, p. 22).

Mayne Logistics E A Rocke said there was a need to address, individually, importations of progressively manufactured large items of plant and machinery imported for assembly into a complete entity in Australia. The current practice does not recognise the commercial realities, including warranty requirements (sub. 39, p. 5).

Digital Audio Technologies referred to the example of local manufacture of longwall mining machines where item 43 had allowed the dutiable components of the system to be imported at the rate applicable to the complete system itself (that is, Free) until 1995. The decision of Customs in 1995 not to issue item 43 determinations for these components was cited as a principal factor in the decision of local manufacturers to cease production (sub. 62, p. 19).

A number of submissions considered that by-law schemes involved significant administrative and compliance costs. For example, the Australian Aluminium Council said that:

> While the [Project By-Law] option is important it imposes administrative and compliance costs and there are uncertainties about whether duty free entry will be granted that can add to the costs of very large projects. (sub. 60, p. 6)

The Pulp and Paper Manufacturers Federation of Australia commented that 'the current system … burdens companies with completely unnecessary costs' (sub. 47 p. 4). The Australian Petroleum Production and Exploration Association Limited also said that 'the administrative requirements associated with processing tariff concession applications is time consuming' (sub. 38, p. 8).

Subsequent to the release of the draft report, the Commission did not receive any further information on the costs to individual businesses of using project and other policy by-laws.

6.4 Evaluating project and other policy by-laws

Project and other policy by-laws, like the TCS, need to be evaluated in terms of their assistance effects and the administrative and compliance costs they impose.

Assistance effects

With the imposition of the 3 per cent duty on business inputs under the TCS, these by-laws can now serve two separate purposes:

- enable duty free entry where a concessional duty of 3 per cent would otherwise be available under the TCS. In this case, there is no substitute local good; and
- enable industry policy considerations to apply where there are substitute local goods available.

Each of these purposes needs to be evaluated separately.

No substitute local good

The evaluation in this case runs parallel to the evaluation of the merits of reducing the concessional rate on business inputs under the TCS from 3 per cent to zero. There are positive and negative effects for community welfare. Overall, however, such a reduction is likely to be beneficial where the concession applies to unprotected (rather than protected) domestic production. Many of the activities assisted under policy and project by-laws fall into this category: in which case — leaving aside administrative and compliance costs — these by-law arrangements are likely to improve resource allocation.

Substitute local good

In this case also, benefits can arise for unprotected domestic activities taking advantage of the by-laws to reduce the costs of inputs. However, because substitute local goods are produced, there will be a reduction in the assistance available to other Australian manufacturers. In principle, this can be positive or negative depending on the level of effective assistance that those manufacturers would otherwise receive. Given, however, the generally low average effective rates for (non-PMV and TCF) manufacturing industries and the manufacturing sector overall, and assuming that the value of goods allowed concessional entry is relatively low compared with the value produced in Australia, the effect is not likely to be significant.

Here too, leaving aside administrative and compliance costs, project and other policy by-laws are likely to be beneficial overall, provided that their scope is confined to unprotected domestic production.

This analysis suggests that, if general tariffs for goods under reference were to remain at 5 per cent for some considerable time, there could be some advantage in expanding the scope of by-laws along the lines requested by participants. Further, if their scope was clearly restricted to inputs to unprotected domestic production, any need for case-by-case analysis of the effects on Australian industry could be reduced. In expanding the scope in this way, however, there would be a need to balance any extra administrative and compliance costs against the overall benefits for the community of such assistance.

Administrative and compliance costs

As with the TCS, the assistance benefits to the community from project and other policy by-laws needs to be set against the cost of administration and compliance. However, little information is available to the Commission about the compliance costs associated with these by-laws — or, indeed, the level of net assistance benefits. Given that applications for by-laws (those under the Project By-Law Scheme and the former Policy By-Law Scheme) must be made on a case-by-case basis, and are subject to a wider range of conditions, the costs of the process per application are likely to be higher than those associated with the TCS. At the same time, however, the assistance benefits are likely to be greater.

6.5 Concessions for exporters

Exporters can gain concessions for duty paid on imports used in exports in three main ways. These are duty drawback, use of the TRADEX scheme and use of the MiB scheme.

Duty drawback

Duty drawback allows exporting companies to claim refunds for payment of customs duty, sales tax or excise duty where these goods will be treated, processed or incorporated in other goods for export or when goods are exported unused since importation.

The refund can be claimed only after the goods are exported. It is not paid unless the exporter notifies Customs of an intention to claim drawback and gives a pre-export notification prior to actually exporting the goods. (Customs may, on request, waive the first requirement.)

Duty drawback is available on most goods, but cannot be claimed where:

- exported goods will be returned to Australia;
- goods have been used in Australia other than for the purposes of exhibition, processing, treatment or further manufacture;
- goods are valued at exportation at less than 25 per cent of their imported value; or
- for excisable goods, the value is less than the amount of the drawback claimed.

Duty drawback payments have been relatively stable at just under $100 million per annum in recent years (see table 6.4).

Table 6.4 **Drawback payments[a] and claims, 1995-96 to 1998-99**

	Drawback payments	*Drawback claims paid*
	$m	No.
1995-96	90.6	10 806
1996-97	96.8	10 496
1997-98	79.0	10 338
1998-99	95.2	10 487

a Drawback payments shown are net amounts — that is, less recoveries and returns.

Source: Australian Customs Service (1999).

TRADEX

TRADEX replaced the TEXCO scheme on 23 June 2000.

The previous TEXCO scheme allowed exporting companies to obtain imported goods free of customs duty or sales tax where those goods were treated, processed or incorporated in other goods for export. The scheme was for companies with either an historical record of exporting or with genuine prospects of future exports and could apply for a specified period or a specific project. However, in cases where the importer was not the exporter of the finished product, both were ineligible.

Duty forgone under the TEXCO scheme fluctuated in recent years (see table 6.5).

Table 6.5 **Duty forgone under the TEXCO scheme**
$ million

	Duty forgone
1995-96	49.0
1996-97	56.7
1997-98	79.8
1998-99	56.6

Source: Australian Customs Service (1999).

AusIndustry estimated that its administrative costs for TEXCO were around $320 000 for 1999-00 (sub. 94, attachment 5).

The new TRADEX scheme aims to reduce further the compliance burden on importers. It provides relief to businesses via an up-front exemption from customs duty and GST on imported goods intended for re-export or to be used as inputs to exports, within one year after their importation. The Scheme builds on and broadens industry access to the benefits delivered by TEXCO, and removes the TEXCO requirement that the goods undergo industrial processing. It also removes the need to ‘drawback’ these charges after export. Thus, TRADEX:

- extends the availability of an exemption-based system for customs duty and GST, thus reducing the compliance costs for users compared with duty drawback — a drawback facility will still be available where, at the time of import, it was not known that goods would be re-exported or used as inputs to exports; and
- relaxes some regulatory arrangements relating to eligibility, registration and on-going compliance requirements with a greater reliance on self-assessment.

However, users are required to maintain appropriate record-keeping and accounting systems for the nominated goods in Australia for a period of 5 years.

Manufacture in Bond

The Government announced that it would provide for MiB and replace TEXCO as part of its *Investing for Growth* industry statement in December 1997. The schemes were in response to a review of tariff export concession schemes which found that excessive access and compliance costs were denying many businesses the chance to recover unnecessary duty and sales tax (DISR 1999).

MiB provides for:

- exemption from customs duty and sales tax on goods imported into a warehouse, licensed by Customs, provided that the goods are subsequently re-exported (either in their original or modified form); and
- deferral of customs duty and sales tax on goods imported into any MiB warehouse and subsequently sold in the domestic market. (Duty and sales tax liability is deferred from point of importation to when goods leave the MiB facility.)

The Department of Industry, Science and Resources regards the main benefits of the scheme as being streamlined import and re-export processes and a decrease in related compliance costs for business.

The Government considers that the scheme can improve Australia’s attractiveness as a site for investment in regional manufacturing, warehousing and hub operations (Moore 1998). Applicants gain approval for MiB from the Department of Industry, Science and Resources by demonstrating that an important part of their business plan is to use Australia as a base for export hub operations. Applicants then need to satisfy Customs requirements for a warehouse licence to manufacture in bond.

MiB was implemented in March 1998. DHL International (Aust) Pty Ltd, a logistics and transport service provider, has licensed a site but as at April 2000 had not operated as an MiB facility.

6.6 Evaluating export concession arrangements

In general, setting aside consideration of administrative and compliance costs, to the extent that concession arrangements assist unprotected domestic production, their use is most likely to be beneficial. Comments on some particular issues are given below.

Duty drawback

The Distilled Spirits Industry Council of Australia Inc. (DISCA) raised some concerns with the operation of duty drawback. It commented that:

> One critical element in the drawback arrangements is to ensure that where drawback is claimed and the exporter is not the original importer, that the amount refunded is not greater than the amount originally paid in duties. DISCA would seek the Government's continued commitment to ensure that the duty drawback arrangements are administered in a fair and equitable manner. (sub. 69, p. 9)

The Council indicated that this problem can arise in cases where the imputation method is used to calculate the amount of duty drawback where import documents are unavailable. The scheme allows duty drawback to be calculated at 30 per cent of the purchase price of the goods. This option can be used only where goods are fully imported and have been purchased in Australia by the exporter.

In the Commission's view, the proper calculation of a duty refund is an administrative, not a policy matter.

Extending duty drawback

In its submission, the South Australian Government called for the extension of 'duty drawback' schemes to 'better assist Australian industry in producing high quality competitive goods' (sub. 81, p. 11). The request was made in the context of postponing reductions in general tariffs until there is 'demonstrated reciprocity in market access' to other countries (sub. 81, p. 9).

By duty drawback, the South Australian Government was referring to 'duty remission schemes where exporting firms can earn credits for concessional imports. In contrast with duty remission programs that require the inputs to be subsequently exported, an extended duty drawback scheme has no requirement that concessional imports be incorporated into exports' (sub. 81, p. 6). The South Australian Government considered that the Automotive Competitiveness and Investment Scheme could serve as a model for 'inexpensive, WTO-compliant assistance to firms' (sub. 81, p. 6). Thus, it recommended that the Commonwealth adopt a more general approach with fewer eligibility criteria and spread access to duty drawback across more sectors (sub. D150, p. 5).

The Commission notes that the Automotive scheme is estimated to provide assistance to the PMV sector of some $2 billion, over a period of 5 years, by lessening the burden of tariffs on inputs for that sector. This can only add to the assistance already provided to this highly assisted sector.

In the context of the present reference, such extended duty drawback arrangements, by allowing some firms to earn export credits which could be sold to other firms to import duty free, would undermine the structure of industry assistance provided by the existing tariffs. Whether or not this would represent an improvement in resource allocation could only be assessed on a case-by-case basis along the lines of the analysis given in section 6.2 in respect of the TCS. The implicit subsidy to exporting firms would depend on the value of the export credits, as would the relief from tariff duty otherwise payable by importing firms.

In the Commission's view, it is better to reduce tariffs and assist all using industries directly rather than to compensate for those tariffs on a selective basis.

Manufacture in Bond

DHL sees value in the MiB scheme as developing a viable Customs scheme that would allow Australia to compete directly with the free trade zones in the region. However, while DHL International (Aust) Pty Ltd licensed a site for an MiB facility in April 1998, it is not yet operational. This is because the company sees two key elements of the MiB package as unresolved.

The first relates to the tariff treatment of goods entering the Australian market (ie cleared for home consumption) from an MiB facility. Suppose particular goods (computer components, for example) are imported into such a facility, transformed (into a finished computer) and subsequently entered into the Australian market. In examples such as this, the finished good (the computer) is treated as its constituent components for the calculation of duty payable. DHL claimed that this can result in an anomaly where the imported components have a higher rate than the finished product — in the computer example, a directly imported finished computer can enter Australia duty free, whereas one manufactured in a MiB facility from imported components is dutiable. DHL said that it had hoped:

> the MiB scheme could have been implemented in a form that overcame such anomalies, and allowed Australian manufacturers to compete on the same level as overseas manufacturers. (sub. 34, p. 2)

However, in the Commission's view, the establishment of MiB is intended to assist Australian manufacturers to increase their export competitiveness. Such facilities should not be used as a method of reducing assistance made available to Australian manufacturers through the tariff. Allowing duty free imports into Australia from MiB facilities in the circumstances outlined by DHL would be both inefficient and inequitable, as it would effectively advantage manufacturers producing finished goods in MiB facilities for subsequent 'export' into Australia at the expense of those producing finished goods in the normal way. The anomaly outlined by DHL needs to be addressed by examining the relationship between general rates of duty imposed on components and on finished goods, rather than by changing the conditions of entry for home consumption from MiB facilities.

Indeed, such an anomaly does not only apply to MiB. A number of manufacturers pointed to the difficulties experienced as a result of the differing rates of duty on components and finished products. For example, Atom Industries, which manufactures a powered lawn edger, pointed to the situation where it is required to pay import duty under the TCS on certain imported engines (not manufactured in Australia) while the finished entire unit enters Australia duty free (sub. 4, p. 1).

The second issue for DHL relates to removal of Customs cost recovery charges. The Commission notes that the Government agreed in April 1999 that these charges would be removed, but the legislation has not yet been passed (sub. 34, pp. 2–3).

MSAS Global Logistics Pty Ltd commented that TRADEX will effectively expand on the TEXCO and MiB schemes by allowing duty and tax free entry to all goods earmarked for export. In view of the licensed warehouse costs associated with MiB, it commented that 'we fail to see any continued need for the retention of the Manufacture in Bond Scheme' (sub. 17, p. 3).

6.7 Implications for concession arrangements of reductions in general tariffs

Any changes in the level of the general tariff would have implications for tariff concession arrangements. In particular, removal of the tariff would remove any need for concessions, making them redundant, at least for practical purposes, in respect of the goods under reference.

In regard to the TCS, in particular, if general tariffs were reduced from 5 per cent, but not removed entirely, the assistance effects of tariff concessions would change. To demonstrate this point, table 6.6 illustrates the assistance effects of tariff concessions when the general rate which would otherwise apply is 2.5 per cent. As with table 6.1, implementing a concessional rate has positive and negative effects when compared with the manufacturing average — allowing for the reduction in that average itself as a result of the reduction in general tariffs for goods under reference.

Table 6.6 **Impact of a tariff concession (general rate of 2.5 per cent) on effective rates of assistance**

	Assembly type manufacturing operation (value added of 25 per cent)			Typical manufacturing operation (value added of 35 per cent)			Elaborately transformed manufacturing operation (value added of 50 per cent)		
	Input nominal rates								
		2.5	$\to$0		2.5	$\to$0		2.5	$\to$0
Output nominal rates	2.5	2.5	10	2.5	2.5	7	2.5	2.5	5
	0	-7.5	0	0	-4.5	0	0	-2.5	0

However, from a comparison with table 6.1, it is apparent that, as general tariffs decline, the positive and negative assistance effects associated with tariff concessions also decline. It is also likely that there would continue to be a net benefit from tariff concessions arrangements, but of a smaller magnitude than when general tariffs of 5 per cent apply. Certainly, as general tariffs approach Free, the net benefit of the TCS similarly falls towards zero.

Reductions in general tariffs would also affect the magnitude of administrative and compliance costs associated with tariff concession arrangements relative to the value of the potential benefits. Users would be less inclined to apply for new TCOs as the magnitude of the possible duty saving decreases — thus compliance costs would decrease. Similarly, as the number of TCOs processed by Customs fell, there should be some reductions in the variable component of administrative costs.

Nevertheless, while general tariffs remain above Free and the TCS continues, total administrative and compliance costs will remain above zero because of the fixed nature of some administrative costs.

This analysis suggests that, as general tariffs are reduced, administrative and compliance costs will begin to exceed the net assistance benefits from use of the concessional arrangements. However, as with the other concession arrangements, the Commission is not able to determine the precise levels at which this will occur.

7 Options

Until relatively recently, Australia's tariffs have been high and disparate, resulting in considerable misallocation of resources. The Australian community has gained substantial net benefits from reductions of those tariffs, particularly since the late 1980s.

The potential net benefits of a further reduction of general tariffs in Australia post-2000 would clearly be smaller than those gained from past reduction programs. This is because the remaining general tariffs under reference are low and relatively uniform — consequently, price distortions in production and consumption are less marked than previously and tariff-induced costs borne by users and consumers are much smaller. In contrast, the high tariffs which remain on passenger motor vehicles (PMV) and textiles, clothing and footwear (TCF) involve substantial costs.

In assessing the scope for further tariff reductions, the Commission has noted Australia's commitment, reiterated in the terms of reference, to the APEC goal of 'free and open trade and investment in the Asia Pacific by 2010 for industrialised economies and 2020 for developing economies'. Although there has been no definitive statement by APEC governments on the meaning of the term 'free and open', further reduction or removal of Australia's remaining general tariffs would be consistent with this commitment.

Understandably, some participants focused on the particular interests of their own firm, industry or region. In the conduct of this inquiry, however, the Commission's primary focus is to improve the wellbeing of the community as a whole. As the Chamber of Commerce and Industry Western Australia indicated:

> These … interests [of particular groups] should be taken into account, but they must be weighed against the wider, more diffuse interests of those who would gain from tariff cuts. The Commission should recommend actions which deliver the best outcome for the whole economy, not just certain sectors, interests or regions within it. (sub. D133, p. 1)

In developing and evaluating options, the Commission has taken into account a wide range of criteria, including:

- the resource allocation effects of tariffs in terms of their production and consumption distortions;

- administrative and compliance costs associated with tariff concession arrangements;
- implications for Australia's trade negotiation strategies;
- interaction with microeconomic reform and continuing structural adjustment;
- schedule for PMV/TCF tariff reform; and
- budgetary consequences of tariff change.

Of particular importance to the consideration of options are the likely adjustment consequences overall, as well as for particular industries, their employees and regions. These are discussed in section 7.2.

7.1 Evaluating the scope for further tariff reductions

The analysis in the preceding chapters indicates that further reductions in tariffs under reference would result in clear, but small gains for the community in respect of most of the criteria outlined above.

Resource allocation

General tariffs on goods under reference distort producer and consumer prices and, hence, production and consumption decisions throughout the economy. Although the average price distortion is not large, being of the order of 3 per cent or less (see section 2.4), its removal could be expected to provide some benefit. Industries which use business inputs currently subject to tariffs would benefit from lower costs. These include export industries, a number of which are located in rural and regional Australia. Australian consumers should ultimately benefit from these lower costs, as well as from the direct price reductions and improved choice flowing from reductions of general tariffs on consumer goods.

As noted above, the benefits are expected to be small relative to those which stemmed from past across-the-board tariff reductions. This assessment is supported by estimates from the quantitative analysis undertaken by the Commission (see chapter 3). There are caveats which must necessarily attach to such analysis, particularly where small policy changes are involved. These caveats mean that, on balance, the estimates are likely to understate actual benefits. Nevertheless, the estimates indicate that, after allowing for adjustment costs, removal of the tariffs under reference would result in a small permanent increase in overall community welfare. There would be some minor reallocation of activity among industries and regions.

Administrative and compliance costs of tariff concessions

A range of tariff concession arrangements provide for reductions in tariff duties which would otherwise apply to imports (see chapter 6). In general, these arrangements either:

- assist some businesses and consumers by allowing the importation of particular goods at concessional rates of duty; or
- assist exporters by allowing the deferral, removal or refund of duty on imported goods subsequently exported or incorporated into exports.

Elimination of general tariffs for goods under reference would render tariff concession arrangements for those goods redundant. As a result, an area of complex regulation could be dismantled, removing what is seen by many domestic producers as an unwarranted nuisance. It also would result in cost savings on government administration and industry monitoring and compliance. These costs are estimated to be in excess of $7 million per annum. The Commission considers that the total magnitude of likely cost savings, including those for importers, is likely to be considerably higher than indicated by the above figure. The duty forgone under the arrangements was almost $400 million in 1998-99.

Reciprocity and trade negotiations

In the past, the majority of the efficiency and welfare gains for Australia from trade liberalisation have derived from unilateral removal of its own trade barriers. Thus, a high cost would have been incurred by Australia if it had postponed liberalisation in the hope that this would have strengthened the nation's negotiating position and allowed Australia to 'win' additional 'concessions' from other countries.

Although overall gains from further reductions in the general tariffs under reference are likely to be small, and the costs of delay less, the issues remain the same:

- would the retention of general tariffs of 5 per cent enhance Australia's negotiating strength and result in additional 'concessions' from other countries; and
- if so, would any such 'concessions' outweigh the costs imposed on Australian firms and consumers by delay in trade liberalisation?

Australia benefits significantly from the bilateral discussions and negotiations with other countries on trade matters which occur continually as part of the normal world trading environment. However, the scope for profitable bilateral trade-offs, involving tariff reductions by Australia in exchange for trade 'concessions' by another country is quite limited. Any 'concessions' granted or obtained on a product or country basis — for example, increased market access recently negotiated by Australia with countries such as China —must be extended to third countries.

Similarly, because of Australia's small share of world trade, it is unlikely that retention of general tariffs at 5 per cent would bring any significant practical increase in Australia's limited bargaining strength in a multilateral context. In fact, the Department of Foreign Affairs and Trade suggested that unilateral trade liberalisation might even increase Australia's negotiating strength (see chapter 5) — trade negotiations usually proceed on the basis of bound rates, so that the bigger the gap between applied and bound rates, the more scope there is for trade-offs in negotiations. On this basis, DFAT, the Australian APEC Study Centre and Professor Ross Garnaut considered that a decision to eliminate all general tariffs ahead of the Bogor commitments could significantly elevate Australia's role in the WTO and APEC in pursuit of freer world trade, including reduced foreign barriers to Australian exports.

Microeconomic reform and structural adjustment

In the Commission's view, general microeconomic reform facilitates the adjustment consequent on tariff reductions (see chapter 4). In other words, broad ongoing microeconomic reform supports the case for tariff reform, rather than being an argument against it. This is because groups adversely affected by a particular reform, such as tariff reductions, are more likely to receive offsetting benefits where microeconomic reforms are implemented on a broad front. Similarly, ongoing structural change and growth also support the case for further tariff reductions — small adjustments are easier to adapt to in an environment of ongoing growth and change than in a static environment.

Schedule for PMV and TCF tariff reform

No further tariff reform for the PMV and TCF sectors is scheduled until 2005. This has two implications for reductions in general tariffs:

- industries which use a relatively high proportion of the products of those sectors as inputs into their own activities could be adversely affected by tariff reductions for goods under reference made earlier than 2005; and
- such reductions would increase the levels of assistance already accorded the highly assisted PMV and TCF sectors.

In each case, however, the effect is likely to be only minor (see chapter 4), particularly when compared with ongoing distortions arising from assistance to the PMV and TCF industries.

Budgetary consequences

As noted in section 2.2, total removal of general tariffs for goods under reference would reduce government revenue by about $1.1 billion per annum. (This would be offset slightly by additional tax revenue as a result of marginally higher levels of economic activity flowing from the tariff reductions.) In addition, there could be some marginal reduction in GST revenue. These revenue reductions represent a transfer from the government to the non-government sector, not a net loss to the community.

This reduction in budget revenue is not significant in relative terms, as the revenue from tariffs on goods under reference accounts for well under 1 per cent of Commonwealth revenue and is small even compared with the average annual growth in Commonwealth tax revenue during the past decade.

7.2 Adjustment issues

To the extent that future tariff reductions could have adjustment consequences for particular industries and regions — whether beneficial or adverse — these need to be seen in the context of continual structural change occurring at the industry and regional levels (see section 4.1). Changes in general economic conditions (such as changes in overseas markets, new technology, population growth and variations in exchange rates) are an important part of that context. So, too, are changes in government policies to foster long-term economic growth, protect the environment, provide public infrastructure and assist the disadvantaged in the community.

The Australian Industry Group predicted that, on the basis of a survey of members, a reduction in general tariffs 'would clearly have serious consequences for the Australian economy' (sub. 63, p. 7). However, as discussed in chapter 3, the survey has deficiencies which undermine its value as a predictor of the consequences for the manufacturing sector of further general tariff reductions. The results of this survey are also noticeably more pessimistic than those from a survey by Australian Business Ltd (ABL) of its members, which also has some limitations. Further, many participants were relatively unconcerned about any direct consequences for Australian industry from further tariff reductions — their concern focused on achieving greater access to markets in other countries.

The overall adjustment consequences of removing the tariffs under reference are likely to be small, because the economic effects of their removal are likely to be small — as noted above, the average price effect is of the order of 3 per cent or less. Corresponding effective rates of assistance for broad industry sectors range between about 2 and 7 per cent.

Further, natural advantage factors such as freight on imports and the convenience for customers of local supply will continue to 'protect' local manufacturers against imports, irrespective of the level of general tariffs. In many cases, these factors could even outweigh the small effects of any tariff reductions, ensuring continued sales of the local product. Penrice Soda Products, for example, indicated that its local production of soda ash and sodium bicarbonate was:

> supplied mostly just in time and if this was replaced by imports the inventory cost to users will more than offset the reduction in tariff. (sub. D129, p. 5)

ABL recognised that price was just one element of competitiveness:

> Non-price competitiveness — quality, innovation, timeliness, customer responsiveness, management/marketing competence — is the essential second half of competitiveness. And this is especially the case as our industries move up the value added curve as they must to maintain Australia's relative living standards. (sub. D131, p. 4)

A further factor limiting the possible consequences of general tariff reductions is the high level of awareness and general acceptance of Australia's APEC commitments. Because of this, further tariff reductions are likely to have featured in the forward planning of many firms and industries, mitigating any concentrated adjustment consequences as those reductions take place. PaperlinX (previously part of Australian Paper), for example, has constructed a new $330 million fine papers machine at Maryvale in Victoria. This machine commenced production during 1998, well after Australia's 1994 APEC commitment to 'free and open trade and investment' by 2010. Although the size of the Australian workforce employed in the pulp and paper industry has been reduced significantly — with flow-on effects to families and regions — investment such as that by PaperlinX should ease any future adjustment consequences for particular firms, employees and regions.

Finally, by reducing input costs, tariff reductions would alleviate the need for adjustment by other industries, regions and people which may arise from other sources of change.

Adjustment consequences of tariff reductions for particular industries and regions

Specific mention was made by participants of possible adverse consequences in stainless steel sink manufacturing, paper production, fabrication of aluminium, some chemicals and plastics manufacture, truck assembly and manufacture and the furnishing and steel industries. Although much of the activity in question is in major urban areas, some adverse consequences for regional Australia were considered likely to accompany further tariff reductions. For example, the Pulp and Paper Manufacturers Federation of Australia considered that tariff reductions would 'compromise the future of a major value adding import replacement industry' (sub. 47, p. 5). The National Association of Forest Products Industries Communities claimed that 'the economic wellbeing of the three regions, where fine paper mills are located [Maryvale, Vic. and Burnie and Wesley Vale, Tas.], is dependent on the Australian industry remaining viable' (sub. 11, p. 3). In that context, an AMCOR fact sheet states that:

> The construction of the state-of-the-art M5 office papers machine in 1998 significantly reduced PaperlinX's production costs. PaperlinX also maintains a cost advantage over international producers in transport and distribution due to its close proximity to the market. PaperlinX has in place a strategy to continue to lower the costs of production and distribution …

Kenworth, a truck manufacturer based in Bayswater Victoria (sub. D136), and Volvo (sub. 52, sub D. 103), which assembles trucks at its plant near Brisbane, opposed any reduction to the 5 per cent tariff applying to the industry. They argued that any reduction in tariff would have a severe impact on their operations, including possible closure, as the importers of completely built-up units (CBUs) would gain substantial benefits from tariff reductions. Many companies supplying components and parts to the truck industry considered that they also would be adversely affected by general tariff reductions. However, supply to the remaining Australian truck assemblers and manufacturers represents only a small part of output for some of those companies.

The Commission's analysis shows some possible adverse effects from tariff reductions on the industries singled out by participants (see table 7.1). In general, however, the estimated magnitude of the effects, relative to the base case, is small. The analysis shows a mixture of marginal increases and decreases in value added and employment in industries and regions, nine years after removal of general tariffs under reference.

A comparison of the estimated relocation of jobs among regions resulting from the removal of the tariffs under reference with recent changes in regional employment provides a perspective on the magnitude of potential regional employment effects. This indicates that in all but one of the 57 regions examined, the estimated effect of removing the tariff under reference, relative to the base case, is either to increase employment or to reduce it by an amount which would be equivalent to less than one year of recent employment growth or loss.

The analysis of the regional employment effects of removing the tariffs suggests that some participants might be factoring the effects of other economic changes into their predictions. All industries are subject to continuing competitive and adjustment pressures from a number of sources, of which tariff reductions are just one.

Table 7.1 **Estimated effects of general tariff reductions — selected industries and regions**[a]

percentage deviations from base case values

Industry and region	*Real value added*	*Employment*
Industry		
Basic iron and steel	0.11	-0.32
Sheet metal products	0.36	-0.75
Pulp, paper and paperboard	-0.92	-1.70
Fabricated metal products	-1.10	-1.99
Industrial, organic and inorganic chemicals	-0.48	-0.88
Motor vehicles and parts[b]	-0.04	0.02
Fabricated wood products	-0.14	-0.71
Region (and main centre)		
Gippsland Vic. (Traralgon)	0.01	-0.06
Mersey-Lyell Tas. (Burnie)	0.07	-0.04
Illawarra NSW (Wollongong)	0.12	0.03
Barwon Vic. (Geelong)	0.07	-0.01
Central Highlands Vic. (Ballarat)	0.01	-0.06
Murrumbidgee NSW (Wagga Wagga)	0.01	-0.05
Hunter NSW (Newcastle)	0.17	0.08
Northern SA (Whyalla)	0.12	-0.04
Wide Bay-Burnett Qld (Maryborough)	0.04	-0.05

a Results reported are estimates for nine years after implementation. **b** Includes passenger motor vehicles and trucks.

Source: PC estimates based on MONASH.

Adjustment assistance

If further tariff reductions for goods under reference are to be made, consideration needs to be given to how to minimise and mitigate adjustment costs. This could be done in several ways — such as by providing a period of notice of tariff reductions or phasing their introduction. The possible need to provide more time for planning, retraining and job seeking by such means turns on a judgment about the size of the benefits and costs of further tariff reductions.

The Commission's analysis indicates that the adjustment pressures faced by particular industries and regions, whilst potentially significant for some people and firms, would be slight overall. Nevertheless, the South Australian Government considered that South Australia would be 'unfairly burdened with a large proportion of the industry and labour adjustment costs' of further general tariff reductions (sub. D150, p. 2). It considered that:

> before any tariff reductions are implemented, adequate adjustment assistance for affected regions and industries must be put in place. (sub. D150, p. 3)

Although the estimated adverse employment effects are more significant in aggregate for South Australia than any other State or Territory, their magnitude is still small, with the largest estimated effect being a reduction in employment, relative to the base case, of 0.3 per cent in the South East region. While the estimates can indicate which regions are likely to be most affected by tariff reductions, they cannot predict which individuals and families are most likely to need assistance. In that connection, the provision of adjustment support by the social security safety net and labour market programs to those who might be adversely affected by change, whatever its source, can be valuable. Of course, such support is intended to be transitional. As argued strongly by the National Association of Forest Products Industries Communities, its members 'do not want social security assistance, we want to remain working for a wage in a viable and growing industry' (sub. D127, p. 2).

In the Commission's view, specific adjustment assistance for the South East region (or, indeed, for any other region in Australia) would not need to be considered unless larger adjustment problems were to emerge unexpectedly. This would involve judgment about a range of efficiency and equity concerns. The Commission's recent report into the *Impact of Competition Policy Reforms on Rural and Regional Australia* gave some detailed consideration to the rationale for specific adjustment assistance. Box 7.1 summarises some of the main findings reached after a workshop held by the Commission in May 1999 explored relevant policy issues associated with structural adjustment.

7.3 Options for tariff concession arrangements

The concessional tariff of 3 per cent under the Tariff Concession System and some project and other policy by-laws raises a modest amount of revenue for the government — less than $200 million a year. At the same time, it imposes a competitive disadvantage on Australian manufacturers who use those inputs, as well as raising costs borne by their customers. Reduction of the concessional rate to Free (zero), as requested by participants, is estimated to bring net efficiency benefits to the economy, after accounting for adjustment costs.

Box 7.1 The Commission's findings about adjustment assistance

Governments should rely principally on generally available assistance measures (ie the social 'safety net') to help people adversely affected by policy induced adjustment pressures. The effectiveness of these measures should be kept under review. This general approach has a number of advantages.

- It treats people in similar circumstances equally.
- It addresses the net effects of reform.
- It can account for unforeseen circumstances.
- It concentrates on those in genuine need.
- It supports families and people rather than a particular industry or activity.

The direct and indirect costs and benefits of an adjustment package, relative to the costs and benefits of relying on general measures, would influence whether measures additional to the safety net were warranted.

Management of the reform process will need to draw on:

- genuine and effective community consultation;
- governments coordinating their responses to adjustment difficulties; and
- monitoring of outcomes.

Where governments decide that specific adjustment assistance is warranted to address any large, concentrated costs, such assistance should:

- facilitate, rather than hinder, the necessary change;
- be targeted to those groups where adjustment pressures are most acutely felt;
- be transparent, simple to administer and of limited duration; and
- be compatible with general 'safety net' arrangements.

Source: Adapted from PC (1999a).

3 per cent duty on business inputs under the TCS

Many participants pointed out that the particular rationale given for the imposition of the 3 per cent duty, of helping to reduce the budget deficit, no longer applies. Nevertheless, it is important to take account of efficiency implications in considering whether a Free concessional tariff for business inputs should be reinstated.

The Commission's quantitative analysis suggests that, overall, if general tariffs were to remain at 5 per cent, there would be a net efficiency benefit from a reduction of the concessional rate to Free. This is mainly because this reduction would remove the current penalty imposed on unassisted areas of activity in mining, agriculture and manufacturing.

If general tariffs were reduced below 5 per cent, but not eliminated, the net assistance benefits from the TCS arrangements would be likely to diminish relative to their ongoing administrative and compliance costs. Conceptually, the arrangements could be discontinued once the costs began to exceed the benefits. On the information available to it during this inquiry, the Commission is not able to determine the precise point at which this would occur.

However, even with general tariffs at 2.5 per cent, there would probably be some small net community benefit from continuing to include business inputs within the scope of the TCS and setting a concessional rate for them of Free.

In the draft report, the Commission linked the removal of the 3 per cent business input duty with the reduction of general tariff rates to Free on 1 July 2001. In response, many participants contended that the community would benefit from an immediate reduction to Free of the concessional rate for business inputs under the TCS. For instance, the Australian Industry Group stated that:

> as an immediate priority, the Government should reduce the rate of tariff on business inputs imported under the Tariff Concession to 'Free' … (sub. D122, p. 1)

Similarly, Atom Industries stated:

> Why wait 12 months to remove this absurd, unjust and discriminating tax? There is nothing hard in deciding and implementing the lifting of the 3 per cent import tax immediately … (sub. D149, p. 4)

As with any tariff change, there could be some adjustment costs associated with removal of this 3 per cent tariff, with possible displacement of output and employment from certain areas as resources relocate to the activities benefiting from the removal of the duty. Such costs would be minimal, however, and there is likely to be little advantage from giving a period of notice of such a change. This is because those directly affected by the change are likely to benefit from it.

Further, the effect on government revenue of the concessional rate reduction would be very small — revenue collected under the TCS for goods under reference in 1998-99 was of the order of $190 million.

Thus, although the focus of this inquiry is on post-2000 general tariffs, the Commission has concluded that there would be merit in reducing the 3 per cent tariff on business inputs under the TCS to Free as soon as possible.

Project and other policy by-laws

As with business inputs under the TCS, there would be merit in reducing the concessional rate of duty under project and other policy by-laws for goods under reference to Free, where a higher duty currently applies, as soon as possible.

The original intention of the project and many other policy by-laws appears to have been to allow concessional duty free entry for certain types of goods where the Government believed, on industry policy grounds, that such concessional entry was warranted, but that the normal criteria of the generally available concession scheme (now the TCS) could not be met (for example, because substitute goods are produced in Australia). In recent years, however, the application of these by-law items appears to have become more restrictive. As a result, use has declined significantly.

The Commission's assessment is that these by-laws are likely to be net contributors to economic welfare where they assist unprotected (as distinct from protected) domestic production. This suggests that, if non-zero general tariffs continued for some time, there would be merit in expanding the scope of the by-law items along the lines requested by participants — for example, by reducing the project threshold from $10 million to $5 million. Further, if their scope was clearly restricted to inputs to unprotected domestic production, then any past need for detailed case-by-case analysis of the effects on Australian industry could be reduced. In expanding their scope in this way, however, there would be a need to balance any extra administrative and compliance costs against the overall assistance benefits for the community.

7.4 General tariff options

The central question for this inquiry is the rate or rates of general tariff that should apply for goods under reference on and from 1 January 2001. Although further reductions of general tariffs, by themselves, are unlikely to result in significant increases in real incomes of Australians, they remain part of an important wider policy agenda. Continued implementation of policies, including tariff reform, designed to improve the structure and performance of the economy will raise community welfare. Removal of tariffs on the goods under reference would also be consistent with the policy objective agreed by all Australian governments that barriers to competition should be removed unless they can be shown to be in the community's interest.

The Australian Industry Group criticised the Commission for not including in the draft report a specific option relating to the retention of existing general tariffs through to 2010. It contended that the draft report 'options amount to an attempt to redefine and limit the decision space within which it believes the Government should be focusing its attention' (sub. D122, p. 3). In fact, in deriving general tariff options in the draft report, the Commission first considered the case for maintaining the status quo — that is, making no unilateral tariff changes in the decade to 2010. It concluded that this would unduly delay overall community benefits, small though they are likely to be, while providing no worthwhile advantages in terms of easing adjustment pressures. The Commission remains of this view — in contrast to the four specific options considered in the draft report, all of which involved the reduction of general tariffs to Free, at various dates, but no later than 2005, a status quo approach offers no advantages whatsoever. Accordingly, the specific options which should be considered by the Government remain as in the draft report:

- set general tariffs at Free (ie zero) in the near future — say, 1 July 2001 — to obtain the gains as soon as practicable;
- set general tariffs at Free following a longer period of notice — say, 1 January 2003;
- phase general tariffs down with a reduction to 2.5 per cent on 1 July 2001 and set at Free on 1 January 2003; and
- set general tariffs at Free on 1 January 2005 to coincide with the scheduled reduction in PMV and TCF tariffs.

An early reduction to Free of the current 3 per cent duty for business inputs under the TCS would reduce somewhat the magnitude of the remaining benefits and remaining costs of each of these options. Nevertheless, in respect of each of the options discussed below, net benefits of general tariff reductions, exceeding those from the reduction in the concessional tariffs, would remain available to be gained. Moreover, each of the options has the effect of removing 'nuisance' tariffs — ie those applied to goods not produced in Australia. The options would do so in a much easier manner than that used to date.

Option 1: Free in the near future — say, 1 July 2001

Essentially, this option brings the earliest practicable realisation of the benefits arising from tariff reductions.

A strong advantage of this option is that it would also allow the early removal of the tariff concession arrangements for goods under reference. As well as bringing early administrative and compliance cost savings, this option would remove any need to give detailed consideration to apparent shortcomings of those arrangements. As noted in chapter 6, some participants questioned whether the underlying intent of project and some other policy by-laws was being met and criticised some aspects of administration.

Tariff reductions in this period would coincide with the changes to business tax arrangements. A first reduction in the company tax rate (to 34 per cent) was made on 1 July 2000, with a second reduction (to 30 per cent) on 1 July 2001. The introduction of the GST in July 2000 will also assist Australian exporters. The benefits arising from those changes could help to offset any adjustment costs for manufacturers arising from tariff change.

Australia's trade negotiation position is unlikely to be weakened and could be strengthened by these unilateral reductions made early in the process of continuing WTO negotiations.

The main disadvantage of the early removal of general tariffs is that it would give less time to those firms and their employees that could experience some difficulties in adjusting to, on average, a 3 per cent price reduction for their output. The government revenue consequences would also be more immediate.

Option 2: Free following a longer period of notice — say, 1 January 2003

This option would delay the realisation of benefits but give affected industries and their employees additional time to plan for the future and to adapt to the estimated small adjustment consequences. The revenue consequences for government could also be dealt with over a longer period.

Administrative and compliance cost savings from removal of the tariff concession arrangements would also be delayed. However, the need to review these arrangements in detail could be avoided if it were decided to accept the costs associated with them for the additional 18 months.

Option 3: Phase down, with a reduction to 2.5 per cent on 1 July 2001 and set at Free on 1 January 2003

This option has a combination of the advantages and disadvantages of the first two single step options discussed above. It aims to bring early community-wide benefits by making an early reduction in tariffs, but also aims to ease adjustment, and the revenue consequences for government, by delaying the second step for 18 months. As with option 2, the need to review concession arrangements could be avoided.

Option 4: Free on 1 January 2005 to coincide with the scheduled reduction in PMV and TCF tariffs

Under this option, the overall community benefit would be delayed for almost four years, as would the administrative and compliance cost savings from abolition of concession arrangements. Such a long period of notice would provide even more time for planning to cope with a 3 per cent price reduction and the consequent small adjustment consequences.

This option would avoid a temporary period of reduced assistance for producers reliant on inputs from the PMV and TCF sectors and allow more time to plan for the government revenue consequences. In addition, it has the minor advantage of avoiding additional assistance for the already highly assisted PMV and TCF sectors, as the general tariff reductions for goods under reference would occur at the same time as those for these sectors.

By delaying reductions to 2005, however, Australia might well forgo the benefits of early unilateral reductions in applied tariffs in the context of continuing WTO negotiations.

Given the criticism from participants of some aspects of the tariff concession arrangements, the Commission considers that it would be undesirable to allow them to continue unchanged until 2005. Thus, delaying removal of general tariffs would necessitate some earlier and detailed re-evaluation of the policy rationales and administrative procedures for tariff concession arrangements.

7.5 Recommendations

Clearly, the 3 per cent tariff on business inputs under the TCS should be removed as soon as possible. As discussed in section 7.3, there would be a net benefit and delay would not affect adjustment costs. At the same time as the business input tariff is reduced, non-zero concessional tariffs under project and other policy by-laws for goods under reference should also be reduced to Free.

RECOMMENDATION 1

The concessional tariff rates for business inputs under the Tariff Concession System and for policy by-law items 43, 47 and 52 be reduced to Free as soon as possible.

With respect to general tariffs, no single option stands out as clearly superior when assessed against the criteria outlined earlier in this chapter.

The early removal of the remaining general tariffs would enable the earliest practical realisation of the overall community benefits arising from such an action. It would also strengthen the perception that world-class performance is necessary for economic success in Australia. There would be benefits for some firms and people as a result of reductions in their costs. Others would incur adjustment costs, which are similarly assessed to be marginal, capable of being met by the generally available social safety net arrangements and not requiring extensive phasing-in periods. Little significant effect on labour in any industry or region is likely.

A further benefit arising from the earlier removal of the general tariffs under reference would be the ability to abolish the associated tariff concession arrangements. An area of complex regulation could be dismantled, with savings to government, and larger savings to businesses, freed of monitoring and compliance with such regulation. If the tariffs were not set at Free by at least 2003, it is the Commission's view that the Government would need to undertake a detailed consideration of the policy objectives and administrative shortcomings of the current arrangements.

The retention of tariffs would make no significant practical difference to Australia's limited bargaining strength in trade negotiations. In contrast, their removal could enhance Australia's efforts to bring about future trade liberalisation of benefit to Australian industries, including export industries in rural and regional Australia.

The option of a later tariff reduction — say, in 2005 — would avoid a temporary period of reduced assistance for producers reliant on inputs from the PMV and TCF sectors. It would allow more time to plan for the government revenue consequences, although there is no evidence that such a long period would be needed. On the other hand, it would delay the benefits likely to accrue to the community, necessitate amendments to the concession arrangements, add nothing to Australia's position in international trade negotiations and provide no significant lessening of any adjustment problems. If the 2005 tariff removal option was to be adopted, it would need to be legislated well in advance, in order to provide a predictable environment for decision-making and to reap international trade negotiation benefits.

Overall, the Commission considers that there is a sufficient weight of positive factors to suggest that the tariffs under reference should be reduced to Free sooner rather than later. It has therefore focused on the first three options. The choice between these options turns largely on the weight given to adjustment and government revenue considerations, relative to the overall net community gain.

Option 2, setting the tariffs at Free on 1 January 2003, would provide a longer period of notice than Option 1 for industries and their employees and enable the Government to adjust to the reduction in its revenue more easily, while deferring the benefits to the general community. Option 3 stages these effects over two steps. Given that the overall benefits are likely to outweigh the marginal adjustment costs, the Commission has a preference, on balance, for Option 1, setting the tariffs at Free on 1 July 2001. It is also of the view that this should be done no later than 1 January 2003.

RECOMMENDATION 2

General tariff rates under reference be reduced to Free sooner rather than later, preferably on 1 July 2001 and no later than 1 January 2003.

Adoption of this recommendation would then make the TCS and the policy by-laws redundant in respect of goods under reference.

A Conduct of the inquiry

A.1 Introduction

Following receipt of the terms of reference, the Commission placed advertisements in metropolitan newspapers inviting public participation in the inquiry. Information about the inquiry was circulated to people and organisations likely to have an interest in it. The Commission also released an issues paper to assist parties in preparing their submissions. Subsequent information about the progress of the inquiry was sent to those who have expressed an interest.

A draft report was released for public comment in May 2000 with feedback on that report invited from participants and other interested parties.

The Commission received a total of 164 submissions during the inquiry — 95 were received prior to the release of the draft report with a further 69 subsequently. Submissions are listed in section A.2.

During the course of the inquiry informal discussions were held Melbourne, Sydney and Canberra with a number of interested parties as listed in section A.3. As well, preliminary public hearings were held in January 2000 with further public hearings held in June 2000 after the draft report was released. Participants are listed in section A.4.

A technical workshop was held on 3 April 2000 to discuss preliminary quantitative analysis of the effects of tariff reductions (see section A.5 for the names of attendees).

Inquiry information, including public submissions and public hearing transcripts, has been made available progressively during the course of the inquiry on the Commission's website (http//www.pc.gov.au).

A.2 List of submissions

The following table lists submissions received. All submissions containing confidential information have been denoted with an asterisk (*). Those with the prefix 'D' were received following the draft report.

Table A.1 **List of submissions**

Participant	*Sub. No.*
ABB Transmission and Distribution Limited	82
Acacia Medical Equipment	91*
ACI Crown Glassware	72
Air Radiators Pty Ltd	D113
AME Systems Pty Ltd	D119
ASSEMCO	D147
Atom Industries	4, D149, D151*
Austral Wright Metals	13
AustralChem Pty Ltd	78*
Australian Aluminium Council	60
Australian APEC Study Centre	48
Australian Business Limited	D131
Australian Chamber of Commerce and Industry	44, D153
Australian Customs Service	93, D161
Australian Electrical and Electronic Manufacturers’ Association Limited	41
Australian Industry Group	63, 67, D122
Australian Music Association	D140
Australian Musical Imports	D97
Australian Organics Pty Ltd	21
Australian Paint Manufacturers’ Federation Inc.	22, D135
Australian Paper	53
Australian Petroleum Production and Exploration Association Limited	38
Australian Stainless Steel Development Association	30
Australian Steel Association Inc	18, 27
Bacardi-Martini, Inc.	74
Barry Johnston	D98
BHP Steel	57, 83, D117
Binzel Pty Ltd	71
Bolwell Corporation Pty Ltd	D128
Bonlac Foods Limited	58*
Bradken Pacific Wodonga	D141
Brushware Manufacturers’ Association of Australia	37, D157
Caltex Australia Limited	12
Chamber of Commerce and Industry Western Australia	D133
Clark Australia	29
Colan Products Pty Limited	66*
Concept Music	D126
Confédération Européenne des Producteurs de Spiritueux	54, D102
Construction & Mining Equipment Association of Australia	75
Crown Equipment Pty Ltd	90*
Customs Brokers Council of Australia Inc.	50

Participant	*Sub. No.*
Department of Foreign Affairs and Trade	65
Department of Industry, Science and Resources and AusIndustry	94
DeWalt Industrial Power Tool Company Pty Ltd	15
DHL International (Aust) Pty Ltd	34
Digital Audio Technologies Australia	62
Distilled Spirits Council of the United States	16
Distilled Spirits Industry Council of Australia Inc.	69, D132
Dr D Hampshire	10
Dunkley International Pty Ltd	3
Eaton Pty Ltd	D125
Elsum Engineering (Aust) Pty Ltd	D115
Email Metals Distribution	9
Fédération des Exportateurs de Vins et Spiritueux de France	79
Flexible Drive Agencies Pty Ltd	D105
Godfrey Office Equipment Pty Ltd	D104
Holland Hitch Aust Pty Ltd	D108
Huck Australia Pty Ltd	D118
Hunter Douglas Limited	23
Huntsman Corporation	35, D130
INC Corporation Pty Ltd	D120
Independent Paper Group	33*, D137
International Packaging Machinery	45
ISONET	56, 84
Japan Spirits & Liquors Makers’ Association	70
Jenkin Bros Engineers (Australia) Pty Ltd	D107
Kaal Australia Pty Ltd	19, D101
Kenworth Trucks	D136
Laminex Industries	49, D138
Mayne Logistics E A Rocke	39, 85, D162
McArthur Composites Pty Ltd	D110
Medical Industry Association of Australia	59
Meritor Heavy Vehicle Systems Australia Limited	D116
Michael Haywood Trade Consultants Pty Ltd	32, D112
Monsanto Australia Limited	31*, D144
MSAS Global Logistics Pty Ltd	17
Murray Goulburn Cooperative Co Ltd	64*
National Association of Forest Products Industries Communities (Inc)	11*, D127, D146
National Farmers’ Federation	76, D163
National Furnishing Industry Association of Australia	28
New Holland Australia	D155
Nickel Development Institute	36
Norman G Clark (A/Asia) Pty Ltd	D124

Participant	Sub. No.
NSW Farmers’ Association	77, D160
NSW Minister for Small Business (Sandra Nori, MP)	95, D143
Occidental Chemical Corporation	7
Orica Australia Pty Ltd - Qld	D128
Orica Australia Pty Ltd - Vic	43
P.W. Hannah & Associates (International) Pty Ltd	73*
Panasonic Australia Pty Ltd	55
Penrice Soda Products Pty Ltd	68*, D129
Pentarch Pty Ltd	86
Philips Electronics Australia Limited	14
Plastic Products (SA)	6
Plastics and Chemicals Industries Association (PACIA)	40, D123
Polystyrene Australia Pty Ltd	5, D114
Printing Industries Association of Australia (PIAA)	24
Professor Ross Garnaut	D164
Pulp & Paper Manufacturers Federation of Australia	47
Qenos	26, D111
QNI Pty Ltd	20
Royal Volunteer Coastal Patrol	88, D96
Segafredo Zanetti Australia Pty Ltd	46
Shoalhaven Manufacturers Association Inc.	61
Shorko Australia Pty Ltd	8*
Sonoco Australia Pty Ltd	D154
South Australian Government	81, D151
South Pacific Tyres	D121
State Chamber of Commerce (NSW)	80, D158
Stev-Tex Laboratories Australia Pty Ltd	3
Sunbeam Corp Ltd	87
Tasman Sinkware Pty Ltd	1
Teco Australia Pty Ltd	D159
The Australian Gas Light Company (AGL)	D139
The Chamber of Minerals and Energy of Western Australia Inc	D109
The Scotch Whisky Association	51, 92, D100
Thomas & Betts Pty Limited	D156
Tolliday Customs Agency Pty Ltd	2
Toowoomba Foundry Pty Ltd	D142
Union Carbide Chemicals (Australia) Pty Ltd	89*
Uniweld Engineering	D106
Volvo Truck Australia Pty Ltd	52, D103
Wilson Transformer Company Pty Ltd	D134
Winemakers’ Federation of Australia Inc	25, D99
WMC Resources Ltd	42
WTO Watch Qld	D145

A.3 Discussions

Informal discussions were held with the following interested parties:

- Australian Chamber of Commerce and Industry
- Australian Customs Service
- Australian Electrical and Electronic Manufacturers’ Association Limited
- Australian Industry Group
- Australian Paint Manufacturers’ Federation
- Australian Workers Union
- BHP
- Brushware Manufacturers’ Association of Australia
- Council of Small Business Organisations of Australia
- Department of Foreign Affairs and Trade
- Department of Industry, Science and Resources
- Eastman Chemical Ltd
- Heavy Engineering Manufacturers Association
- ISONET Limited
- Laporte Organics
- National Association of Forest Products Industries Communities
- National Furnishing Industry Association of Australia
- Packaging Council of Australia

A.4 Public Hearings

Public hearings were held in Melbourne, Canberra and Sydney during January 2000 and, following the release of the draft report, in Melbourne and Sydney in June 2000. Those appearing are listed in table A.2.

Table A.2 **Public hearings**

Participant	Transcript page nos.
Melbourne Hearing – 19 January 2000	
• National Furnishing Industry Association of Australia	1 – 16
• Plastic Products (South Australia)	17 – 20
• Henselite Australia Pty Ltd	21 – 26
• Laminex Industries Pty Ltd	27 – 47
• Plastics and Chemicals Industries Association	48 – 64
• Qenos Pty Ltd	65 – 81
Canberra Hearing – 21 January 2000	
• ISONET Ltd	82 – 95
• DHL International	96 – 103
• Australian Chamber of Commerce and Industry	104 – 109
• Winemakers Federation of Australia	110 – 119
• Pulp and Paper Manufacturers Federation of Australia	120 – 130
Sydney Hearing – 27 January 2000	
• Mayne Logistics E.A. Rocke (also representing Volvo Truck Australia)	132 – 143
• Atom Industries	144 – 146
• BHP	147 – 160
• Printing Industries Association of Australia	161 – 167
• Australian Industry Group	168 – 190
• The Scotch Whisky Association (also representing The European Confederation of Spirits Producers)	191 – 199
• Australian Stainless Steel Development Association (also representing Stainless Steel Tube Mills)	200 – 204
Sydney Hearing – 28 January 2000	
• Australian Aluminium Council	206 – 220
• Kaal Australia	221 – 230
• NSW Farmers' Association	231 – 241
• Rodda Castle and Co	242 – 254
Melbourne Hearing – 28 June 2000	
• National Furnishing Industry Association of Australia	2 – 12
• Australian Musical Imports	13 – 22
• Kaal Australia Pty Ltd	23 – 36

Participant	Transcript page nos.
• Penrice Soda Products	37 – 52
• Qenos	53 – 63
• National Association of Forest Products Industries Communities	64 – 75
• Plastics and Chemicals Industry Association	76 – 90
• Volvo Truck Australia Pty Ltd	91 – 101
• Kenworth Trucks	102 – 127
• INC Corporation Pty Ltd	112 – 127
Sydney Hearing – 29 June 2000	
• Australian Industry Group	129 – 151
• New South Wales Minister for Small Business and Tourism	152 – 160
• Atom Industries	161 – 168
• Broken Hill Proprietary Company	169 – 181
• Australian Business	182 – 189
• AustralChem Pty Ltd	190 – 198

A.5 Technical workshop

The following organisations and individuals attended the technical workshop.

- ACT Dept of the Treasury
- Australian Bureau of Agricultural and Resource Economics
- Australian Chamber of Commerce and Industry
- Department of Finance and Administration
- Department of Foreign Affairs and Trade
- Department of Industry Science and Resources
- Department of the Treasury
- Dr John Madden (engaged by the Commission as a referee)
- Dr Robert Albon
- Dr Rod Tyers (engaged by the Commission as a referee)
- ISONET – ACT
- Dr John Quiggin
- Prof Ron Duncan (engaged by the Commission as a referee)
- Prof Peter Dixon (engaged by the Commission as a consultant on application of the model)
- Queensland Chamber of Commerce and Industry
- Queensland Treasury
- SA Department of Industry and Trade
- SA Department of Premier and Cabinet
- Vic Department of Premier and Cabinet

B Average applied and bound tariff rates

Chapter	*Description*	*Simple average applied tariff* [a]	*Simple average bound tariff* [a]
		%	%
1	Live animals	0	0.35
2	Meat and edible meat offal	0	0.06
3	Fish and crustaceans, molluscs and other aquatic invertebrates	0	0.18
4	Dairy produce; birds' eggs; natural honey; edible products of animal origin, not elsewhere specified or included	0.14	0.71
5	Products of animal origin, not elsewhere specified or included	0.29	2
6	Live trees and other plants; bulbs, roots and the like; cut flowers and ornamental foliage	0	0.83
7	Edible vegetables and certain roots and tubers	1.25	3.77
8	Edible fruit and nuts; peel of citrus fruit or melons	0.89	2.05
9	Coffee, tea, mate and spices	0	0.06
10	Cereals	0	0.75
11	Products of the milling industry; malt; starches; inulin; wheat gluten	0.59	2.76
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruit; industrial or medicinal plants; straw and fodder	0.56	1.72
13	Lac; gums, resins and other vegetable saps and extracts	0.77	2.15
14	Vegetable plaiting materials; vegetable products not elsewhere specified or included	0	0.70
15	Animal or vegetable fats and oils and their cleavage products; prepared edible fats; animal or vegetable waxes	1.70	3.42
16	Preparations of meat, of fish or of crustaceans, molluscs or other aquatic invertebrates	1.73	6.38
17	Sugars and sugar confectionery	1.94	7.31
18	Cocoa and cocoa preparations	2.27	7.82
19	Preparations of cereals, flour, starch or milk; pastrycooks' products	3.83	6.41
20	Preparations of vegetables, fruit, nuts or other parts of plants	4.10	8.55
21	Miscellaneous edible preparations	1.44	4.00
22	Beverages, spirits and vinegar	3.75	9.55
23	Residues and waste from the food industries; prepared animal fodder	0	4.53
24	Tobacco and manufactured tobacco substitutes	0	12.13

Chapter	Description	Simple average applied tariff [a]	Simple average bound tariff [a]
		%	%
25	Salt; sulphur; earths and stone; plastering materials; lime and cement	0.74	2.99
26	Ores, slag and ash	0	0.55
27	Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes	0.21	2.97
28	Inorganic chemicals; organic or inorganic compounds of precious metals, of radioactive elements or of isotopes	0.42	9.63
29	Organic chemicals	0.81	8.56
30	Pharmaceutical products	0.67	0.52
31	Fertilisers	0	8.57
32	Tanning or dyeing extracts; tannins and their derivatives; dyes, pigments and other colouring matter; paints and varnishes; putty and other mastics; inks	3.37	10.00
33	Essential oils and resinoids; perfumery, cosmetic or toilet preparations	2.79	8.03
34	Soap, organic surface-active agents, washing preparations, lubricating preparations, artificial waxes, prepared waxes, polishing or scouring preparations, candles and similar articles, modelling pastes, “dental waxes” and dental preparations with a basis of plaster	3.91	10.00
35	Albuminoidal substances; modified starches; glues; enzymes	1.25	5.75
36	Explosives; pyrotechnic products; matches; pyrophoric alloys; certain combustible preparations	3.13	10.00
37	Photographic or cinematographic goods	3.29	10.00
38	Miscellaneous chemical products	1.90	8.83
39	Plastics and articles thereof	5.45	10.67
40	Rubber and articles thereof	6.68	14.38
41	Raw hides and skins (other than furskins) and leather	1.94	5.34
42	Articles of leather; saddlery and harness; travel goods, handbags and similar containers; articles of animal gut (other than silk-worm gut)	6.70	13.91
43	Furskins and artificial fur; manufactures thereof	3.26	7.84
44	Wood and articles of wood; wood charcoal	3.67	4.04
45	Cork and articles of cork	1.43	4.29
46	Manufactures of straw, of esparto or of other plaiting materials; basketware and wickerwork	0	0.67
47	Pulp of wood or of other fibrous cellulosic material; recovered (waste and scrap) paper or paperboard	0	1.50
48	Paper and paperboard; articles of paper pulp, of paper or of paperboard	3.99	8.87
49	Printed books, newspapers, pictures and other products of the printing industry; manuscripts, typescripts and plans	2.05	4.32
50	Silk	2.83	12.67
51	Wool, fine or coarse animal hair; horsehair yarn and woven fabric	6.44	9.22

Chapter	Description	Simple average applied tariff [a]	Simple average bound tariff [a]
		%	%
52	Cotton	11.47	26.31
53	Other vegetable textile fibres; paper yarn and woven fabrics of paper yarn	0.48	2.60
54	Man-made filaments	10.95	17.06
55	Man-made staple fibres	11.26	21.42
56	Wadding, felt and nonwovens; special yarns; twine, cordage, ropes and cables and articles thereof	5.42	7.14
57	Carpets and other textile floor coverings	9.97	14.76
58	Special woven fabrics; tufted textile fabrics; lace; tapestries; trimmings; embroidery	8.35	12.72
59	Impregnated, coated, covered or laminated textile fabrics; textile articles of a kind suitable for industrial use	9.32	13.24
60	Knitted or crocheted fabrics	16.61	24.37
61	Articles of apparel and clothing accessories, knitted or crocheted	23.41	39.15
62	Articles of apparel and clothing accessories, not knitted or crocheted	22.37	39.41
63	Other made up textile articles; sets; worn clothing and worn textile articles; rags	12.21	22.37
64	Footwear, gaiters and the like; parts of such articles	11.43	17.59
65	Headgear and parts thereof	3.93	24.00
66	Umbrellas, sun umbrellas, walking-sticks, seat-sticks, whips, riding-crops, and parts thereof	1.43	13.00
67	Prepared feathers and down and articles made of feathers or of down; artificial flowers; articles of human hair	0	2.38
68	Articles of stone, plaster, cement, asbestos, mica or similar materials	4.02	10.00
69	Ceramic products	4.31	9.35
70	Glass and glassware	3.38	10.93
71	Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewellery; coin	1.06	4.95
72	Iron and steel	3.98	5.46
73	Articles of iron or steel	4.84	10.92
74	Copper and articles thereof	3.64	3.73
75	Nickel and articles thereof	0.29	0.29
76	Aluminium and articles thereof	4.17	4.58
78	Lead and articles thereof	0.50	0.50
79	Zinc and articles thereof	0.50	0.50
80	Tin and articles thereof	0	0
81	Other base metals; cermets; articles thereof	0	0
82	Tools, implements, cutlery, spoons and forks, of base metal; parts thereof of base metal	4.29	13.91
83	Miscellaneous articles of base metal	5.56	16.47
84	Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof	3.36	8.38

Chapter	*Description*	*Simple average applied tariff* [a]	*Simple average bound tariff* [a]
		%	%
85	Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles	3.38	9.64
86	Railway or tramway locomotives, rolling-stock and parts thereof; railway or tramway track fixtures and fittings and parts thereof; mechanical (including electro-mechanical) traffic signalling equipment of all kinds	4.79	15.04
87	Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof	6.52	13.38
88	Aircraft, spacecraft, and parts thereof	0	6.05
89	Ships, boats and floating structures	2.67	11.79
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	1.33	3.48
91	Clocks and watches and parts thereof	0.45	2.69
92	Musical instruments; parts and accessories of such articles	0.87	3.95
93	Arms and ammunition; parts and accessories thereof	1.76	4.65
94	Furniture; bedding, mattresses, mattress supports; cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated name-plates and the like; prefabricated buildings	4.93	13.78
95	Toys, games and sports requisites; parts and accessories thereof	3.88	14.89
96	Miscellaneous manufactured articles	3.14	12.81
97	Works of art, collectors' pieces and antiques	0	0.86

a The averages for applied and bound rates are indicative only as each series is based on a different version of the Customs Tariff: the information about applied rates uses the current version of the Tariff, whereas that for bound rates uses the version of the Tariff which was current when the bindings were entered into.

Source: Based on information provided by Customs and DFAT.

C Tariff concession arrangements

This appendix describes the operation of the Tariff Concession System (TCS) and project and some other policy by-laws in greater detail than presented in chapter 6. It also includes more extensive details of participants' comments on the operation and features of the schemes.

Submissions were referred to AusIndustry and the Australian Customs Service for comments. Comments were received from Customs but AusIndustry/DISR said 'it would not be appropriate to respond to such issues at this point of the review.'

C.1 Tariff Concession System

The TCS is a widely available concessional arrangement that provides free or concessional entry to imports in the absence of locally produced substitutes. The TCS provides for:

- duty free entry for goods specifically listed as consumption goods (see item 50A of schedule 4 of the Customs Tariff); and
- a 3 per cent duty for all other eligible goods, ie business inputs (see item 50 of the Schedule).

Background to the TCS

Tariff concession arrangements have existed in one form or another since the introduction of the Commonwealth Tariff of 1901 (see box C.1). They permit certain categories of imports to be brought into Australia at lower rates of duty (usually Free) than would otherwise apply. A common rationale for such arrangements is to allow importers to pay a reduced, or no, tariff when there is no local production to protect.

Box C.1 **Australian concessional arrangements**

Concessional arrangements to provide reduced rates or duty free entry for imports where there is no local production to protect were put in place with the Commonwealth Tariff of 1901. The then Treasurer said:

> Of course, we have put the highest duty upon the complete manufactured product and have imposed a lesser duty upon an article as it approached the raw material … When it cannot be produced locally it is admitted at a low rate, if not free.

The initial concessions to the Commonwealth Tariff were limited to duty free entry for machine tools. In 1926, the criterion for concessional entry was broadened to cover goods, 'of a class or kind not manufactured in Australia'. Consequently, the number of by-laws increased accordingly. Tariff concessions have typically been known as by-laws, being a legal device for eliminating or reducing duties administratively according to specified criteria. Rationalisation of the by-laws occurred in 1948, with the adoption of broad-ranging by-laws for entry of material and manufactures for use in manufacturing, industrial or resource development, public infrastructure or for other 'essential purposes'.

These were replaced in 1957 by a by-law criterion which allowed concessional entry in the absence of 'a suitably equivalent, reasonably available' (SERA) domestic substitute. However, the 'essential purposes' provision remained until 1970. The concessional entry criterion based on the absence of a SERA substitute without an essential purposes provision remained in place until 1983 when it was replaced by the Commercial Tariff Concession Scheme (CTCS). The criteria for granting concessions under the CTCS — which was the predecessor to the current TCS — were based on the absence of locally produced goods 'serving similar functions'.

Source: IC (1991b); Snape, Gropp and Luttrell (1998).

The current TCS was introduced in 1992, replacing the Commercial Tariff Concession Scheme (CTCS) which had been in place since 1983. Like its predecessor, the TCS originally allowed all eligible goods to be imported duty free.

In early 1996, the Commonwealth Government announced its intention to abolish the TCS for business inputs. The Treasurer (Willis 1996) said:

> The Government will abolish the Tariff Concession System with effect from 1 July 1996 in respect of business inputs.
>
> … as the general tariff rate declines the net benefit … becomes much smaller and is outweighed by the costs of the scheme's administration and the compliance cost to business. The BIE estimated that the net cost to the economy could be in the order of $30m.
>
> It is therefore appropriate to modify the scheme in 1 July 1996 when the general tariff rate reduces to 5 per cent in line with the Government's long term tariff reduction program. (p. 1)

Following a change of government and industry concerns that abolition of the TCS would place higher costs on business inputs, the new Government announced that it would retain a modified TCS. The modified TCS — to take effect from 1 July 1996 at the same time as the general tariff was to decline to 5 per cent — was to operate with a concessional rate of duty of 3 per cent for all eligible goods. The Minister for Industry, Science and Tourism, (Moore 1996) announced that the 3 per cent duty would enable business and industry to contribute to improving the budget situation and said:

> While we have limited the impact of any additional cost to industry, we have been firm. Industry will still shoulder its share of the burden needed to meet our commitments and improve the Budget situation. (p. 1)

The prefaced modifications to the TCS were further amended to enable the relevant legislation, the Customs Tariff Amendment Bill 1996, to pass through the Senate. As a result, the current TCS provides for duty free entry of consumer goods and a concessional rate of 3 per cent duty on all other imports.

How the scheme works

The TCS is administered by the Australian Customs Service (Customs). This involves assessing applications made by importers for Tariff Concession Orders (TCOs), granting or denying TCOs and administering the revocation process for TCOs. Customs also undertakes internal reviews as part of an appeals process on the granting or revocation of TCOs. External appeals are dealt with by the Administrative Appeals Tribunal (AAT).

The application process

To acquire a TCO, an importer lodges an application with Customs, describing the physical features of the goods or the various components of the goods, the tariff classification of the goods and the uses of the goods for which a TCO is sought.

'A TCO will be granted on imported goods if substitutable goods were not produced in Australia at the time the TCO application was lodged [see box C.2]. Substitutable goods are Australian made goods which have a use corresponding to the use of the imported goods' (Customs Tariff Concession System Factsheet). The applicant is required to provide details and results of the inquiries undertaken to establish that no substitutable goods are produced in Australia.

Box C.2 What are substitutable goods?

Substitutable goods under the TCS are defined as 'goods produced in Australia that are put, or are capable of being put, to a use that corresponds with a use (including a design use) to which the goods the subject of the application or of the TCO can be put'.

Goods are determined as produced in Australia if they are:

- wholly or partly manufactured in Australia; and
- at least 25 per cent of the factory or work costs are represented by the sum of the
  - value of Australian labour; and
  - Australian materials; and
  - factory overhead expenses incurred in Australia.

Goods are taken to be partly manufactured in Australia if at least one substantial process in the manufacturing process was carried out in Australia. The substantial process in the manufacturing process *does not* include:

- transporting or storing goods:
- improving the packaging or marketing quality of the goods;
- preparing the goods for shipment;
- simple assembly operations; and
- mixing the goods where the resulting product does not have properties different from the goods that have been mixed.

Source: Customs (various).

Because of the information requirements, successful application for a TCO usually requires drawing on specialist expertise. More than 90 per cent of applications are filed by customs brokers or agents on behalf of importers. To examine the availability of locally produced substitute goods, some applicants and their agents use the national network of Industrial Supplies Offices (ISOs). The ISO was proclaimed as a 'prescribed organisation' for the purposes of the TCS in July 1996. Its advice on the absence or existence of local producers is used by Customs in its determination process. ISONET said:

> ISO does not make determinations on behalf of the Australian Customs Service (ACS), but the advice provided to applicants for tariff concession is accepted by ACS and used in their determination process. ISO is the only 'prescribed organisation' to be promulgated to date. (sub. 56, p. 2)

All applications for TCOs are published in the Commonwealth of Australia Tariff Concessions Gazette. This allows domestic manufacturers the opportunity to object before a TCO is granted. Appeals against the granting of a TCO must be made within 50 days after the application is gazetted. Customs then considers the application against the substitutable goods criterion and makes a decision within 150 days of gazettal. If granted, the TCO comes into effect from the date the application was received by Customs. Any goods eligible for a TCO imported in the period between the lodgement of the application and the granting of the TCO are eligible for a refund of the relevant duty. As the TCO pertains to a specific good and not the applicant, once the TCO is granted other importers are able to use the TCO to import the eligible goods on a concessional basis.

Revocations

Once a TCO is granted, a local manufacturer can make an application to Customs to have the TCO revoked where it can demonstrate that its goods are produced in Australia and can be substituted for the goods covered by the TCO. Customs also can initiate revocations.

In 1998-99, industry submitted 82 revocation applications of which 33 were approved. Customs in the same year initiated revocations for 3703 TCOs and Commercial Tariff Concession Orders (CTCOs) — some CTCOs were still in place from the previous scheme. Of Customs-initiated revocations, 93 per cent involved concessions that had not been used in the previous two years or which were considered to describe goods inappropriately in terms of their end use (Customs 1999). There is no specific time limit on a TCO but those which have not been used over the past two years are generally discontinued once reviewed by Customs.

The appeal process

Customs has a process for internally reviewing its TCO decisions on appeal from applicants and domestic manufacturers. In 1998-99, Customs completed 20 such internal reviews. This was a decline from the 49 internal reviews completed in the previous year. External appeals relating to the Customs internal review process and other TCO related decisions can be made to the AAT. In 1998-99, 25 TCO-related requests for reviews of Customs decisions were made to the AAT, a decline from the 31 requests in the previous year (Customs 1998, 1999).

The Excluded Goods Schedule

The TCS does not cover all goods. Certain classes of goods such as food, clothing, footwear and passenger motor vehicles are listed under the Excluded Goods Schedule of the Customs Regulations. The Schedule was established following the 1982 IAC inquiry into the Commercial By-law System to improve the administration of the concession system. It was intended that the Schedule would cover certain classes of goods which had consistently been rejected by Customs for tariff concessions on the grounds that there was continuing local production of substitute goods. The objective was to reduce the administrative load of Customs (IC 1991b).

C.2 Participants' concerns with the TCS

The major concern of participants with the TCS was the 3 per cent concessional tariff on business inputs introduced in 1996. Previously, such inputs could be imported free of duty. A significant number of participants across a range of industries called for the 3 per cent duty on concessions to be removed. Other concerns regarding the TCS related to matters of procedure and administration and the criteria used to determine eligibility. These concerns are discussed below.

The 3 per cent concessional tariff

The introduction of a 3 per cent concessional tariff on business inputs was seen by participants as:

- adding to costs and reducing the competitiveness of Australian manufacturers in both domestic and overseas markets;
- creating circumstances where local manufacturers paid a 3 per cent tariff on their inputs while imports competing with manufactured goods which use those inputs entered duty free; and
- continuing as a source of revenue after the rationale for its introduction — to reduce the budget deficit — had passed.

Costs and competitiveness

Increasing the concessional duty on business inputs from Free to 3 per cent was considered by many participants to have increased costs and adversely affected competitiveness. The Australian Industry Group considered:

> The 3% tariff (tax) imposed on industry under the TCS should be abolished. It is bad policy when assessed against any measurement to improve the international competitiveness of Australian industry. (sub. 63, p. 11)

And DeWalt Industrial Power Tool Company said:

> The imposition of the 3% revenue tax in 1996 on business inputs not available from local manufacture, has added significantly to input costs with an adverse impact on the international competitiveness of our local industries. (sub. 15, p. 5)

The Australian Gas Light Company expressed similar views (sub. D139, p. 2).

Many individual firms noted that removal of the 3 per cent duty would improve their competitiveness. For instance, Caltex Australia said:

> The removal of the tariffs [3 per cent concessional tariff] on catalyst imports would help towards making the refining of petroleum products more competitive with the overseas refineries. (sub. 12, p. 3)

And Email Metals Distribution said:

> Removing the current 3% tariff from stainless steel flat product imports into Australia would have the effect of reducing the cost of manufactured goods produced in this country as compared to the imported finished product. It would also improve Australian manufacturing competitiveness on the export market. (sub. 9, p. 2)

The increase in costs for some Australian industries from the imposition of the 3 per cent duty was seen to be without any offsetting benefit through increasing assistance to others. The ACCI indicated that:

> The TCS was introduced to exempt from tariffs those goods for which there is no locally produced substitute. This policy recognised the fact that no competitive advantage arises for domestic industry from applying tariffs to goods it does not produce, while these tariffs disadvantage business using imported inputs by increasing costs and reducing competitiveness. … As a result of the amendments Australian business has effectively been asked to compete internationally, but with artificially higher input cost. (sub. 44, p. 2)

‘Anomalies’ in protection

Several participants pointed to situations that have arisen with the introduction of the 3 per cent duty whereby local manufacturers now paid duty on imported inputs used to produce goods that competed with duty free imports. This was regarded as anomalous since it involves discrimination against Australian manfacturers. For example, Atom Industries commented on lawn edgers:

> We are the inventors and manufacturers of our innovative patented powered lawn edger which is 100% Australian manufactured, except for the 31 cc and 34 cc petrol engine which are not manufactured in Australia and have to be imported. We have to pay import duty on these engines (Tariff Item 8407.90.30) whereas overseas manufacturers can bring into Australia, the same engines we are using, with the entire unit DUTY FREE under the same Tariff Item No. 8467.89.00 that our lawn edger is classified under. (sub. 4, p. 1)

The budget deficit

As noted above, the concessional duty was introduced in 1996 to raise revenue to assist in addressing the then budget deficit. While not agreeing with the imposition of the duty in the first place, some participants considered that, with the improvement in the budget situation, this rationale no longer applied. For example, the ACCI (1999) said:

> Amendments made to the Tariff Concession Scheme (TCS) in 1996 were explained as a way of business sharing in the burden of the deficit reduction process. The changes resulted in a three per cent tariff on many business inputs as a means to raise revenue. With the budget now well and truly back into surplus, the Government needs to reverse this highly distortionary and anti-competitive revenue measure. (p. 1)

And the Australian Petroleum Production and Exploration Association Limited said:

> While the stated rationale for the decision to increase the rate of duty was to address concerns with the then budget deficit, the failure to revert to the original zero per cent has seriously undermined what is an important provision in the tariff system. Specifically, the current arrangement where a three per cent duty exists is at odds with the broader principle that goods, when imported as business inputs, should not incur a duty if they are not capable of being produced in Australia. (sub. 38, p. 11)

Other concerns with the TCS

Other concerns regarding the TCS related mainly to procedural matters and the criteria used in granting TCOs.

The Australian Petroleum Production and Exploration Association Limited (sub. 38) said that the criterion used to determine substitutability should be widened to include elements such as price, quality, deliverability and safety.

Laminex Industries said that the concept of ‘use’ in the substitutable goods criterion had hindered it from importing complementary products at lower prices, because the company itself manufactured goods that could be put to a corresponding use.

> The outcome is troubling because Laminex import laminates that supplement their manufacturing range where the small volumes involved do not warrant the significant capital costs for manufacturing to cater for a speciality market niche.
>
> Therefore, a definition that confers eligibility based on a market-competitive test rather than the ‘use’ test would overcome the wide interpretation by the Australian Customs Service. It would also enable importer manufacturers to import complementary products at lower prices. (sub. 49, p. 21)

Thus, Laminex considered that changes are desirable to the Tariff Concession System ‘to render it a simpler and more effective instrument of policy, and to base it on a “market competitive” goods test rather than the more abstract “corresponding use” goods test’ (sub. D138, p. 6).

Laminex Industries also said that the criterion that allowed manufacturers with only the ‘potential’ capability to manufacture an item to object to the granting of a TCO had hindered Laminex from obtaining imports at concessional rates and needed to be changed:

> Regarding capital equipment that Laminex imports from time to time to upgrade manufacturing lines or install new processing lines, it is imperative that such purchases are entitled to duty free entry provided no Australian company has manufactured the equipment in the preceding two to three years.
>
> The TCS needs further change to have a ‘compete’ clause or requirement in the definition to preclude manufacturers merely claiming the ‘potential’ to manufacture. (sub. 49, p. 21)

The Australian Paint Manufacturers’ Federation Inc. recommended that immediate steps be taken to address the difficulty companies have in obtaining tariff concession orders for products for which there is only a general or ‘other’ classification (sub. D135, p. 2).

Pentarch Pty Ltd raised concerns about the revoking of existing concessions without notifying the holder of the concession and the timeframe within which a concession is revoked. It said:

> The revoking of a concession by notification only in the Commonwealth Gazette, albeit under an approved process, without advice to the holder of the concession in question appears to be a very dubious process. … the Gazette does not represent every day reading for organisations such as ourselves.
>
> The revoking of a concession after only two years of non-use does not reveal a great understanding of industry when it comes to investment in high cost equipment. It would not be surprising for a concession relating to equipment, which could cost up to several million dollars to remain unused for ten years or so, particularly when the prevailing environment was not conducive to such investments. (sub. 86, p. 1)

The Australian Petroleum Production and Exploration Association Limited (sub. 38) said that the process of gazetting applications for TCOs to allow objections to be raised from domestic producers of substitutes, while transparent, was time-consuming and that there was uncertainty as to whether a TCO would be granted.

Mayne Logistics EA Rocke said the current system had a number of shortcomings:

- The extremely interpretive nature of the Policy criteria used to determine Item 50 eligibility.

- The high monetary cost of preparing, pursuing and administrating individual item 50 concessions.
- The highly controversial method of determining availability of local manufacturer capability in respect of goods the subject of an Item 50 application. (sub. 39, p. 2)

It said that the changes made to the TCS in 1996 whereby the 'onus of proof' was shifted from the manufacturer to the importer to establish that there was no local production were seen to burden the importer with unnecessary costs:

> it seems to be commercially unfair to the importer that they are burdened with the expense of firstly endeavouring to establish the lack of local manufacturer capability prior to the lodgement of an application and are then subject to scrutiny by all local manufacturers who may raise subsequent objections to the granting of an application if they so desire. … The elimination of the need to conduct an up-front assessment of local manufacturer capability by the applicant, would certainly result in a substantial cost saving to the importer. (sub. 39, p. 2)

Shifting the 'onus of proof' from the manufacturer to the importer resulted from the Evaluation of the Tariff Concession System undertaken by Customs (1995). The evaluation found that the local manufacturers, in proving to Customs that local production was established, were incurring substantially higher costs than the TCO applicants without reaping any of the benefits. Shifting the 'onus of proof' to the applicant or importer was considered to be consistent with the need to ensure that the costs associated with the TCS were borne by the beneficiaries.

C.3 Policy by-laws

Background

This inquiry focuses on those by-laws that have been established on industry policy grounds and which formed the Policy By-Law Scheme (until 1 August 1998). Some other policy by-laws are listed in chapter 6 for completeness (see box 6.3). A by-law item could be created for certain types of goods where the Government considered that concessional entry was justified but where the Commercial Tariff Concession System (CTCS) criteria could not be met. (The CTCS was the precursor to the Tariff Concession System.) In May 1988, the Minister for Industry, Science and Technology stated:

> The Government believes that decisions where judgements have to be made concerning the effect on assistance to Australian industry, are better made by the Government through the provision of policy by-laws rather than modifying the parameters of the Commercial Tariff Concession System. By-laws also allow the Government to provide

> concessions targeted to achieve specific industry goals in a way not possible within the Commercial Tariff Concession System. (Button 1988a)

A participant in this inquiry, Digital Audio Technologies Australia, also commented on the original purpose of such by-laws:

> From mid 1989 onwards, the then Federal Government enacted a series of items … to give effect to certain industry specific concessions, intended to permit the entry free of customs duty of goods not otherwise entitled to free entry under Tariff Concession Orders. (sub. 62, p. 13)

Digital considered that, given the criteria which then applied to the assessment of applications for TCOs, the granting of a policy by-law would be certain to have an adverse effect on some local manufacturers:

> the only imported goods which could become the subject of a policy by-law were those in respect of which local industry was already manufacturing substitutable goods AND were imported goods in respect of which the making of a TCO would have a significant adverse effect on the market in Australia for the locally manufactured goods. (sub. 62, p. 14)

Several participants, including Digital, considered that the current administration of policy by-laws was not in accordance with their original purpose.

As indicated by the Australian Customs Service:

> From a policy perspective, the over-riding principle behind the PBL [Policy By-Law] System is to reduce costs to industry where there are sound reasons to do so, through the encouragement and enhancement of investment in Australia. It will be necessary to demonstrate that the anticipated investment will result in the establishment and development of world class mining, resource processing, industrial or downstream processing projects, while at the same time maximising the involvement of Australian manufacturers in these projects. (Australian Customs Notice 96/32)

The Policy By-Law Scheme provided concessional rates of duty on imported goods that could contribute to the Government's industry policy objectives. It provided concessions under items 43, 47, 52, 55 (this item was repealed in 1999), 57 and 60 (box C.3) and under items 45, 46 and 56 (known as the Project By-Law Scheme from 1 August 1998). The Project By-Law Scheme is described in the next section.

The rate of duty on imports entering under items 57 and 60, which relate to selected goods with substantial and demonstrable performance advantages, is Free. Imports under items 43 and 52, which relate to the tariff treatment of split consignments of complete equipment, attract the rate applicable to the whole good. Item 47, which relates to capital equipment that includes certain components that can be made in Australia, attracts a 3 per cent rate.

How the policy by-laws work

To qualify for a concession, importers are required to lodge a detailed request which demonstrates that:

- the goods to be imported satisfy the terms of the relevant item in Schedule 4 to the Tariff; and
- the granting of the concession is consistent with prevailing Government policy.

Each request is considered on its merits. All requests must be made before any goods are imported. It is considered 'fundamental to the objectives of concessional entry under these items that importers seeking concessions should first take steps to maximise the opportunities for Australian manufacturers to produce the particular goods' (Australian Customs Notice 98/22, p. 2).

Requests for items 57 and 60 must also include an independent technical assessment quantifying the precise dimensions of the perceived performance advantage of the imported goods over locally available goods. The request should include:

- names of local suppliers or manufacturers used in the comparison, supported by evidence from the ISO; and
- the relevant qualifications of an independent expert undertaking the technical assessment.

A concessional instrument, which provides the operating detail for implementation of the Policy Items, will identify the particular goods to which it applies and the period for which the instrument will remain in force. This is usually a period of no longer than two years to cater for possible changes in industry policy or domestic manufacturing capability.

Requests to extend the date of effect of an instrument (for example, to cover goods that did not arrive in the period specified in the instrument) require a new application. A new application will also be needed prior to the arrival of any goods that are additional to those identified in an original request or approved in an original concession.

From 15 April 1999, an application for items 57 or 60 and the Project By-Laws needs to be made to AusIndustry, part of the Commonwealth Department of Industry, Science and Resources. Requests for concessional entry for other policy by-law items must continue to be made to the Australian Customs Service. Customs retains responsibility for entry requirements and associated administration and compliance.

Box C.3 Policy by-laws

Items 43 and 52: These items provide for tariff treatment of split consignments of complete equipment. They were established to overcome a situation where tariff treatment of split consignments of complete equipment resulted in the application of more duty to the individual components than would apply if the same goods had been imported as a complete unit at concessional rates. A significant precondition for access to the concession is that the goods must be ordered from, and shipped by, a single supplier. The goods must be available as an identifiable, whole entity at the place of manufacture or export. Broadly, concessional entry is available where:

- there are logical and economically sound reasons for industry to import the components in separate consignments (for example, because of the physical size of the goods or because certain sensitive but integral components must be transported by air); or
- circumstances arise beyond the control of the importer, such as inadvertent transport or shipping delays, which preclude shipment on a single vessel or aircraft.

Item 47: Under the former CTCS, Australian manufacturers could prevent concessions being granted for complete equipment if they produced a major component that could be incorporated into that complete equipment. Item 47 allows importers of such equipment to avoid having to remove, and ship separately, components excluded by a CTCO, or to obtain them locally to gain the benefit of the concession for the balance of the equipment. While the difficulty has been overcome with the introduction of the TCS, the concession is administered through a number of by-laws that relate to certain CTCOs for particular items of capital equipment.

Item 57: This applies to a range of raw materials and intermediate goods (consisting of chemicals, plastics and paper used in the production of certain products) that offer a substantial and demonstrable performance advantage in the production of a specific end product over substitutable goods produced in Australia. Processing which does not alter the essential nature or use of the goods (such as simple cutting, shaping or wrapping) is not eligible.

Item 60: This applies to metal products and goods for use in food packaging that offer a substantial and demonstrable performance advantage in the packaging of goods over similar materials currently made in Australia.

For items 57 and 60, requests for concessions are required to demonstrate that the imported goods are intended for use in export enhancement or import replacement activities that would generate a quantifiable and significant benefit to Australia. In addition, the eligibility criteria for these two items are not linked to a major project consideration.

Source: Australian Customs Service, Australian Customs Notices (98/27 and 96/32), Customs sub. 93.

Background and rationale for some individual policy by-laws

Item 43, dealing with the tariff treatment of single machines imported in split consignments, was introduced in August 1988, taking effect from the beginning of 1988. Prior to this item, importers could gain a concession allowing them to import machinery in split consignments and pay duty at the rate for the complete unit, provided the consignments were sent from a single source and from a single point of departure. The new arrangements were designed to be more flexible. They allowed the importation of split consignments, for machines identified to certain chapters of the tariff, from separate points of departure and from separate sources and still attract a single rate of duty. It also allowed use of the concession when part of the unit was made in Australia. In announcing the changes, the Minister stated:

> Industry should not be penalised if it decides to source a complete unit from several places or if it sources part of the product in Australia.
>
> This will be in accord with the Government's industry policy objectives and with the measures introduced in the May statement to reduce import costs to industry. (Button 1988b)

The Minister added that approval to import would be determined on a case-by-case basis to ensure that there was not any misuse of the concession that might affect component manufacturers. The Australian Customs Service was to examine each request, in consultation with the Department of Industry, Technology and Commerce, and be subject to ministerial approval.

Under the original arrangements for item 43, concessions were granted on a shipment-by-shipment basis. In 1991, the administration of the concession changed to allow consideration on a broad project basis. According to Customs, this was found to disadvantage local component manufacturers (contrary to Government policy). As a result, administration was tightened in 1995 so that concessions were granted only for specific goods (sub. 93, attachment A).

A new by-law, item 52, covering capital equipment such as off-road dump trucks and locomotives, was announced in the *'Building a Competitive Australia'* statement of March 1991 (DPM&C 1991). The procedures and conditions for eligibility were the same as for item 43.

Items 43 and 52 were subsequently amended to reflect the previous narrower coverage. An attachment to Australian Customs Notice 96/32 in 1996 indicated that split shipments from different suppliers in different locations were no longer eligible for concessional treatment under items 43 and 52.

Item 47 related to goods, including components, ineligible for CTCOs. Under the former Commercial Tariff Concession Scheme (CTCS), Australian manufacturers could prevent concessions being granted for complete capital equipment if they produced a major component that could be incorporated into that complete equipment. Where a major component was manufactured locally, importers were forced to remove and ship separately the major component or obtain that major component locally, in order to obtain a CTCO.

Item 47, which applied to certain capital equipment for use in the mining, construction and agricultural sectors, was introduced in 1989 to overcome this situation.

The Government announced, when introducing this item, that it had:

> … decided to allow complete capital equipment duty free entry under the Policy ByLaw System where a Tariff Concession has been granted for items of capital equipment with the exclusion of parts that could be made in Australia. This will enable importers of such capital equipment to avoid the costly process of removing components excluded from the Tariff Concession Order from the capital equipment concerned, shipping these components separately or obtaining them locally, in order to obtain the benefit of the duty free concession for the balance of the equipment. (Button 1989, p. 3)

The decision-making process under Item 47 focused on the likely impact concessional imports would have on Australian manufacturing capability (Australian Customs Notice 96/32).

The Australian Customs Service indicated that new by-laws under item 47 are unlikely to be made given that the TCS does not have the same shortcomings as its predecessor, the CTCS (sub. 93, attachment B).

The intent of Item 60, introduced in 1992, is to enable the Australian food processing industry to improve its international competitiveness and enhance export growth (Australian Customs Notice 98/27).

C.4 Project By-Law Scheme

The Project By-Law Scheme permits certain capital equipment for major projects to be imported free of duty where it can be demonstrated that equipment with comparable characteristics could not be manufactured in Australia. It is aimed primarily at assisting major projects in the mining, resource processing and agriculture-based industries. However, major projects across other industry sectors may also be eligible for the concession, provided that the capital equipment is technologically superior to that produced in Australia (box C.4). As mentioned above, the Project By-Law Scheme covers items 45, 46 and 56 in Schedule 4 of the Customs Tariff.

Box C.4 **Project By-Law Scheme**

Item 45

This covers capital equipment for use in the mining and resource processing industries. For item 45, appropriate industrial activities are those which recover minerals or transform and add value to primary or natural resources within the mining or resource processing project concerned. Primary inputs can be from recycled or waste products generated from a separate or integral industrial process. Primary and intermediate stage resource processing activities are included. Consideration may be given to final stage processing or waste recycling activities provided that they are integrated with earlier stages.

Transportation activities, such as pipelines, and infrastructure proposals, such as stand-alone power stations that are not dedicated to an industrial activity, are not eligible.

Item 46

This covers capital equipment for use in the agriculture, food processing and food packaging industries. The capital equipment must be for use in an activity, which produces, transforms or adds value to agricultural or food products. Primary and intermediate stage food processing and food packaging are acceptable activities. Final stage food processing is an acceptable activity provided that it forms part of an integrated food processing operation.

Item 56

This item covers 'state of the art' capital equipment that is more technologically advanced, more productive or more efficient than equipment currently available from Australian manufacture. Factors taken into account in assessing an application include:

- greater speed in completing a process or increased output over time;
- greater flexibility in performing tasks — for example, through being able to switch between tasks or tooling or greater flexibility in changing production schedules and production runs;
- lower unit production costs;
- lower operating costs;
- ability to attain improvements in or meet recognised quality standards (which may include stringent environmental controls); and
- increased productivity.

Source: Australian Customs Service, Australian Customs Notice (98/22).

Background and rationale for individual Project By-Laws

Item 45 (goods designed for use in the mining industry) and Item 46 (goods designed for use in the agricultural industry) were introduced in 1989 to encourage the establishment of major new development projects by allowing duty free entry of certain goods. The concessions applied to equipment not made in the normal course of business in Australia.

The Government's 1989 announcement emphasised that the measures were designed to boost Australia's main export industries by lowering their costs. The Minister for Industry, Technology and Commerce said:

> The policy changes would significantly reduce import costs to create a more competitive trading environment and encourage industry to become more internationally competitive. (Button 1989)

The changes were made in response to the Industries Assistance Commission Report on the Mining, construction and agricultural equipment industries and were an extension of earlier policy decisions relevant to those industries (IAC 1988b). These earlier decisions included across-the-board tariff reductions introduced in the May 1988 Economic Statement and termination of the agricultural equipment bounties in April 1989.

In its industry statement on 12 March 1991, *Building a Competitive Australia*, the Government announced its intention to introduce a policy item to allow for duty-free entry of state-of-the-art capital equipment not made in Australia (DPM&C 1991). This was done to supplement earlier decisions to allow duty-free entry of mining, minerals processing, agricultural and construction equipment. The Government stated:

> Australian industry importing capital equipment can face impediments to enhancing their international competitiveness at present under the Commercial Tariff Concession System criteria. This is because goods serving similar functions and having significantly lower performance may be available from local manufacturers. (DPM&C 1991, p. 5.51)

A new policy by-law was introduced in 1991 to allow for the duty free importation of state-of-the-art capital equipment. Item 56 was intended to:

- improve the competitiveness of the purchaser of capital equipment by allowing duty free access to imported equipment if it was better in certain respects than comparable locally made equipment;
- encourage the purchaser to source locally in other cases through the maintenance of the duty; and

- encourage local suppliers to improve their equipment by removing the duty otherwise payable on imported equipment if the imported equipment was superior in certain respects.

Some changes were subsequently made to the operation of items 45 and 46. On 15 July 1996, the Australian Customs Service announced the following amendments:

- item 45 became 'capital equipment (rather than goods) for use in the mining and resource processing industries'; and
- item 46 'capital equipment (rather than goods) for use in the agricultural, food processing and food packaging industries' (Australian Customs Notice 96/32).

At the same time, the new project-based eligibility threshold (of $10 million or more for capital equipment) for concessions for items 45, 46 and 56 was announced.

How the scheme works

A request is processed in two stages:

Project advice

On the basis of information supplied by the applicant about the project, AusIndustry will assess whether the project meets certain policy criteria — namely, whether:

- the request is prospective;
- the project has been advertised;
- the project satisfies the capital equipment eligibility threshold of $10 million;
- the project meets the specific policy requirements for the relevant item; and
- for item 56, the imported equipment falls within an eligible tariff classification.

Goods request

After an applicant's project advice is accepted, AusIndustry will consider *goods requests* (for particular items of capital equipment) that have been lodged for the particular project. Applicants need to establish a clear and direct link between the particular goods for which they seek a concession and the project advice. Applicants must also publicly advertise in national newspapers or trade journals and with relevant industry associations for expressions of interest to supply from Australian manufacturers.

For items 45 and 46, applicants must demonstrate that the equipment (see box C.5 for capital equipment guidelines) for which duty relief is sought could not be manufactured in Australia. This can be done by:

- identifying a Tariff Concession Order for the equipment which is in force when the goods request is lodged; or
- providing a statement from the Industrial Supplies Office stating that it is not aware of an Australian manufacturer producing or capable of producing the equipment or an equivalent good (see box C.6) for the applicant's project.

Applications need to be made before importing the equipment.

Box C.5 **Capital equipment guidelines**

A project by-law can be granted only to certain classes of capital equipment. To qualify, the equipment must comprise:

Significant items of machinery: Factors to determine eligibility include value, importance to the project, specificity of design, complexity and dimensions. Goods such as nuts, bolts, screws, gaskets, connectors and cables are unlikely to be considered significant.

Certain types of machinery: The concession generally applies only to machinery classified within nominated Chapters of the Tariff. However, in some cases goods classified outside these Chapters (for example, a sub-sea flexible flowline) may still be eligible if the goods consist of highly complex interactive parts; are specifically designed for use in the relevant industry and require only simple assembly to form a complete unit.

Equipment integral to and used directly in: Only equipment that is integral to and for direct use in appropriate industrial activities is eligible. Goods which are ancillary to the project (including but not limited to office equipment and equipment used in activities such as land preparation, road and building construction, personnel accommodation and transportation, off-site transportation and the provision of electrical, water, telecommunications and other general services) are excluded.

Industrial activities appropriate to the Policy By-Law item: Covered in box C.4.

Exclusions: Material inputs and consumables such as paints, lubricants, fuel, refractory bricks, sheeting, coils, etc are not eligible. Spare parts (whether replacement, commissioning or otherwise) and installation equipment are also ineligible.

Source: Australian Customs Service, Australian Customs Notice (98/18).

For duty concessions under Item 56, applicants must support their claims with independent technical assessment reports. These reports need to quantify the degree of technological advancement, efficiency or productivity of the imported capital equipment compared with what is, or could be produced in Australia. For item 56 concessions, there must be goods made in Australia with which the imported equipment can be compared. Where there is no local manufacture, applicants could seek a concession using the TCS, although the duty rate is 3 per cent (rather than Free for item 56 concessions).

Box C.6 What is an equivalent good and what are the criteria to determine Australian manufacture?

The ‘equivalent good’ criterion is a more design-specific criterion than the ‘substitutable good’ criterion applicable to a TCO. Goods are equivalent if they meet the applicant’s engineering and technical requirements. They do not have to meet the applicant’s unduly specific criteria (such as proprietary materials or technologies).

There is Australian manufacture of the equipment if an Australian manufacturer is willing to accept an order to supply the equipment and has:

- produced an equivalent good in the last 2 years before the Project By-Law Scheme goods request was lodged; or
- produced an equivalent good, which is held in stock in Australia; or
- produced an equivalent good in Australia on an intermittent basis in the 5 years before the Project By-Law request was lodged; or
- made equipment requiring the same labour skills, technology and design expertise as the imported equipment in the 2 years preceding the lodgement of the Project By-Law Scheme goods request and is able to produce the equipment with existing facilities.

Customs does not consider price differentials, ability to meet supply time frames or unduly specific design criteria as relevant factors when assessing applications.

Source: Australian Customs Service, Australian Customs Notice (98/22).

The Project By-Law Scheme increases reliance on the Industrial Supplies Office Network (ISONET) in identifying potential Australian suppliers.

A Project By-Law concession is available only where the purchase price of all capital equipment for the project (for equipment from Australia and overseas) exceeds $10 million for each significant phase of a project. Eligibility for downstream stages of a project will be assessed independently of the initial stage.

In announcing the Project By-Law Scheme, the Minister for Industry, Science and Tourism indicated that the new scheme would make by-law applications quicker and easier to process (Moore and Truss 1998). Decisions on requests for a project advice would be made within 25 days (previously 30 days) while those on a goods request within 90 days (previously 120 days).

C.5 Participants' views on by-laws

Many inquiry participants commented on the operation and features of the policy by-laws including the Project By-Law Scheme. While many criticised aspects of the administration (see below), none called for the removal of these by-law arrangements. A number of participants (see chapter 6, box 6.4) saw value in the policy and project by-laws, particularly those importing expensive capital equipment where the saving in import duty could be considerable. In the case of project by-laws, the duty reduction is removal of the duty that would otherwise apply.

Are objectives being achieved?

The Pulp and Paper Manufacturers Federation of Australia called for reform of the project by-law arrangements and stated that:

> The pulp and paper industry experiences major difficulties with the operation of the Project By-Law arrangements.
>
> Despite the clear intention of Government policy that pulp and paper making machinery should enter Australia duty free, the way this policy is interpreted and implemented under these arrangements makes this impossible to achieve in practice. (sub. 47, p. 4)

Accordingly, it recommended that:

> The Project By-Law arrangements need to be reformed in order to ensure that the policy intention that imports of pulp and paper making machinery should enter Australia duty-free, is actually realised in practice. (sub. 47, p. 5)

Murray Goulburn Co-op Co. Ltd. stated that for project by-laws there was scope for AusIndustry to make 'its delivery of that program more responsive to the needs of industry and the overall intent of Government policy' (sub. 64, p. 10).

These sentiments were supported by comments made in the submissions by Bonlac Foods Limited (sub. 58, p. 7) and P W Hannah & Associates (International) Pty Ltd (sub. 73, p. 5).

Digital Audio Technologies Australia requested that 'the original principles underlying the PBL [Policy By-Laws] system be reintroduced and given proper effect according to that beneficial intent' (sub. 62, p. 15).

By-law administrative and compliance costs

A number of submissions considered that some of these schemes involved high administrative and compliance costs.

The Australian Aluminium Council said that:

> While the [Project By-Law] option is important it imposes administrative and compliance costs and there are uncertainties about whether duty free entry will be granted that can add to the costs of very large projects. (sub. 60, p. 6)

The Pulp and Paper Manufacturers Federation of Australia commented that 'the current system … burdens companies with completely unnecessary costs' (sub. 47, p. 4).

The Australian Petroleum Production and Exploration Association Limited also said that 'the administrative requirements associated with processing tariff concession applications is time consuming …' (sub. 38, p. 8).

$10 million threshold for Project By-Law Scheme

As noted above, the new project-based eligibility threshold of $10 million for concessions available under items 45, 46 and 56 was introduced on 15 July 1996 (Australian Customs Notice 96/32).

Murray Goulburn Co-op Co. Ltd. stated that:

> … as current administrative arrangements seek to exclude significant expenditure on equipment that is typically found throughout a modern manufacturing facility in the dairy industry, that Government should give consideration to permitting the total investment being made to be that measured against the $10 million benchmark, or alternatively that the $10 million benchmark itself be reduced to $5 million or less. (sub. 64, p. 11)

Laminex Industries supported reduction of the $10 million to $5 million threshold for the Project By-Law Scheme (sub. 49, p. 22 and D138, p. 6).

Michael Haywood Trade Consultants Pty Ltd went further in recommending 'that the $10 million benchmark for project by-law status be abolished' (sub. 32, p. 4).

MSAS Global Logistics Pty Ltd supported this view and urged that the Commission consider a recommendation that this threshold be eliminated since it is discriminatory to small business. It said:

> … why should a small to medium sized Australian business expending less than than A$10 Million in capital outlay be excluded from receiving assistance in favour of a

> multi-national expending A$10 Million or more. Surely, provided the overall policy objectives are being addressed the amount expended should not matter. (sub. 17, p. 4)

Similarly, the South Australian Government recommended that the $10 million benchmark be eliminated. It said:

> The benchmark unnecessarily discriminates against and harms small and medium-sized firms, who are subsequently forced to pay higher input costs than large firms for the same product. (sub. 81, p. 11)

Digital Audio Technologies Australia said that:

> And limitation of concessions under item 45 to projects involving outlays on capital equipment exceeding $10.0 million now means that the mining industry has to pay duty again on goods that were intended to enter duty free from mid 1989 onwards. (sub. 62, p. 21)

Role of ISO

ISOs were established in all States and the Northern Territory in the mid-1980s with the objective of assisting industry to obtain more of its requirements within Australia.

The role of the ISO for the policy by-law system was outlined by the Minister for Customs in October 1995:

> The ISOs are …ideally suited to providing information to potential PBL [Policy By-Law] applicants on Australian capability and competitive Australian suppliers for a range of industry sectors. (Schacht 1995)

Changes to the Customs Act in July 1996 led to the introduction of the concept of a ‘prescribed organisation’ for tariff concession applications. A ‘prescribed organisation’ is one that intending applicants for a tariff concession can contact for assistance in determining whether a manufacturer of substitutable goods exists, prior to importation and application for duty relief. The ISO is the only prescribed organisation to be promulgated to date.

Concerns were raised by Mayne Logistics E A Rocke (sub. 39, pp. 4–5) on the role of the Industrial Supplies Office (ISO) in determining local manufacturer capability. It said:

> It is no secret that the primary role of the ISO is to encourage and foster Australian Industry and Manufacture. To require such an organisation to act as an impartial adjudicator in determining the extent of such local manufacture capability in respect of specific goods being imported for a major project, seems to be a conflict of interests. (sub. 39, p. 5)

Thus, it questioned whether the ISO should have responsibility to assess whether particular goods produced in Australia are capable of performing required functions for specific projects under the Project By-Law system.

However, the ISO saw no conflict of interest in its role. It is able to work with proponents in the early stages to identify the scope for Australian industry involvement. It indicated that its involvement in the process merely allows Customs to verify that the importer has been through the proper procedures (trans., p. 92).

On another matter of adding to compliance costs, the Australian Petroleum Production and Exploration Association Limited commented that:

> … there is a clear duplication of measures associated with local industry participation requirement (ie the ISO process and national advertising). (sub. 38, p. 8)

By-law definitional difficulties

What is a ' project'?

The Australian Petroleum Production and Exploration Association Limited indicated that for many projects within the oil and gas industry, item 45 does not always cover the totality of a project. For example, it does not cover the interconnecting pipeline for an offshore production facility, which the Association regards as an integral component of a wider project. It stated that:

> The exclusion of this portion of the project, particularly where a pipeline represents an integral component of a wider project, is discriminatory and illogical. (sub. 38, p. 8)

Further, it pointed out that while the use of the TCO process provides a useful mechanism to short-circuit a potentially time-consuming phase of the process, it ignores the problem that not all items eligible for a TCO are ruled eligible for a policy by-law.

APPEA recommended the following amendments to the current policy by-law arrangements:

- a new PBL item be created for large-scale projects over a certain threshold limit amount;
- a more comprehensive definition of what constitutes a project should be adopted;
- a self-assessment type of system for eligible claimants be considered; and
- intermediate goods used by Australian manufacturers be eligible for full duty relief. (sub. 38, Executive Summary)

The Australian Gas Light Company stated that:

> The original intent of Item 45 provisions was to assist mining (which includes oil and gas) and mineral processing and related projects, yet the current interpretation seems to exclude any project not physically sited on a mining lease or an oil and gas production lease. (sub. D139, p. 3)

What is capital equipment?

Digital Audio Technologies Australia said that in regard to item 45, the repeal of the wording of the by-law to read 'capital equipment' instead of 'goods' in mid-1996 meant that:

> … parts of capital equipment cannot be imported duty free unless they also happen (fortuitously) to be capable of identification as 'capital equipment'. (sub. 62, p. 21)

Mayne Logistics E A Rocke considered that Customs placed an unduly restrictive interpretation on the term 'capital equipment' (sub. 39, p. 5).

Appropriate criteria?

Digital Audio Technologies Australia stated that the present guidelines for *item 57* exclude packaging materials from consideration, despite the fact that many goods used as 'packaging' are technologically advanced and contribute to a significant degree to the use of the contents. Also, it stated that:

> It is a major anomaly in item 57 that this by-law can be used to permit duty free entry of raw materials and intermediate goods if there is a locally manufactured substitute, but this is not available to permit duty free entry of goods for which local industry does not produce a substitute. (sub. 62, p. 24)

In a similar vein, MSAS Global Logistics pointed to what it saw as an anomaly in the coverage for eligibility for *item 56*. To gain the concession, equipment must be compared with that which is currently available from Australian manufacture. It does not apply in situations where there is no manufacture in Australia. Accordingly, it suggests that, where there is no local manufacture of the equipment under consideration, then it should be seen as automatically technologically more advanced and thus eligible for the concession (sub. 17, p. 4).

Application of the split consignment provisions

Australian Customs Notice 96/32 indicated that a precondition for access to split consignment concessions was that the goods concerned must be ordered from, and shipped by, a single supplier. This was in contrast to the previous situation that allowed machines to be manufactured and imported progressively because of their size, and allowed the components to be shipped from various overseas ports.

Mayne Logistics E A Rocke considered that there were problems with the operation of item 43 relating to split consignments. It said there was a need to address, separately, imports of progressively manufactured large items of plant and machinery imported for assembly into a complete entity in Australia. The current practice does not recognise the commercial realities including warranty requirements. Further, unless the items of equipment are able to meet the terms of item 43 for split shipment provisions then each importation is regarded as 'imported' both for duty assessment and local manufacturer capability. It added:

> It is obvious that either amendments to the current legislation or at the very least, a more realistic and commercial approach needs to be adopted by the Government in their assessment of equipment of this nature.
>
> … there has been many millions of dollars required to be paid on imported equipment because of the present policy interpretation on goods for which there is no way that any locally produced equipment could be considered as a viable commercial substitute. (sub. 39, p. 5)

The Australian Petroleum Production and Exploration Association Limited said:

> … for projects the size of LNG developments, the split consignment provisions within the PBL system can impose administrative constraints on the way that equipment must be imported to ensure that full duty relief can be obtained. (sub. 38, p. 8)

Digital Audio Technologies Australia referred to the example of local manufacture of longwall mining machines where item 43 had allowed the dutiable components of the system to be imported at the rate applicable to the complete system itself (that is, Free) until 1995. The decision of the Australian Customs Service in 1995 not to issue item 43 determinations for these components was cited as a principal factor in the decision of local manufacturers to cease production (sub. 62, p.19).

Michael Haywood Trade Consultants Pty Ltd pointed to a change in the interpretation of the split consignment concessions (item 43) which resulted:

> … in many cases, in large projects incurring unnecessary duty imposts as well as imposing large additional administrative workloads on applicants with having to itemise large component imports with policy requirements being applied to each component good under individual tariff items.

Further, item 43:

> … greatly assisted major projects covering, for example paper and pulp making machines and steel rolling mills. These machines are classified under single tariff classification in the Customs tariff but because of their immense size, cannot be manufactured other than progressively and cannot be imported other than

> progressively. And by allowing the components to be shipped from various overseas ports removed the uneconomic and pointless practice of shipping the components from overseas ports to the one port of export before shipping to Australia. (sub. 32, p. 6)

They suggested that the split consignment provisions be changed back to that operating on and from 1 January 1988 (sub. D112, p. 2).

Laminex Industries supported the view that the 'delivery of current policy on importations of large single functional capital equipment is detrimental to industry and needs to be revised' (sub. 49, p. 22).

Customs advised that the changes to the split consignment provisions 'were made for budgetary reasons and to streamline the policy by-law system so that all concessions for projects would be dealt with under item 45, 46 or 56' (sub. 93, appendix 1, p. 9). It expressed concern that a return to the original provisions of item 43, would restore the overlap between item 43 and the project by-law items and create administrative difficulties.

Other by-law matters

Duty relief is provided under Item 22 to goods for use in oil and petroleum explorations and the development of fields to the stage at which commercial production is practical. APPEA recommends that duty relief provided under this item 'should be maintained and streamlined to ensure that cumbersome administrative arrangements are removed and that duplications of exclusions are deleted' (sub. 38, Executive Summary).

Customs advised that an exclusion list and a substitutable goods test apply for administrative ease and to reduce the risk of ineligible goods being imported under item 22. It also advised that changes will be made to overcome the anomaly in the temporary import provisions relating to goods used in the exploitation of natural resources, highlighted by APPEA (sub. 93, attachment A).

Volvo commented that the removal of Item 41B would have an adverse impact on its operations. It would mean that imported componentry would be subject to the general rate of duty, increasing the duty payment for trucks, and rendering the company uncompetitive in the local market (sub. 52, p. 2).