The Manufacturers Group Submission to the Productivity Commission into Post-2005 Textile, Clothing and Footwear Assistance Arrangement.

March 2003

This submission is to be read as an addendum to the South Australian Government Submission to the Productivity Commission Inquiry. The group supports the South Australian Government's submission as wishes to add these views.

Summary.

There is a strong and sound future for the TCF&L industry in Australia. Present models relate to the economic concept of *ceterus paribus,* where we all know that we live in a changing world. Interest rates, exchange rates, and infrastructure costs will all be in Australia's favour over the next two decades. Interest rates will rise, third world currencies will strengthen, the cost of adhering to social and environmental restraints will increase, infrastructural costs will increase, labour will become less important. The wheel will turn. The question is: Will Australia have enough retained skills to grasp the opportunity?

The entities left in the industry are generally those with the strength, ability and will to survive. Now that the dead wood has, in general, been pruned it is important to feed and nurture. This requires nutrients, water and importantly the removal of weeds. (Weeds are wild, grow where they are not wanted, and suck the nutrients from the cultivated pastures.)

The major costs in the supply chain have not been addressed. The main objection to manufacturing in Australia is the cost of labour. However labour cost is a very small component of the final cost of most products. Economics of the future will be very different to those of the past. The ability of technology to deliver solutions to the questions of distribution and retail will change the supply chain landscape significantly in the near future.

The nature of capital will change. The differentiation between risk and non risk capital will widen. The cost of risk capital will increase. In time the cost of capital in risk enterprises will outweigh the cost of labour.

The coming generation will seek, in a career, a mixture of financial reward, job satisfaction, lifestyle and kudos. The TCF&L industry offers an exciting future for young Australians. The industry is full of opportunities and challenges. It will be the role of the Commonwealth Government to show the generation to come that there is a bright and sustainable future in an industry that has been despised through the last decades.

Recent Performance and Future Prospects

- Companies focused on manufacturing as a key strategic driver for their business have enhanced performance in terms of profitability, ROI, market share, quantity of exports, improvement in productivity and product quality. Companies that have a singular focus on marketing and a policy of outsourcing manufacturing have struggled in the areas of productivity, product quality, and level of exports.
- Restructuring of the industry has reduced the number of nuisance players that skew the market towards being totally price driven. This has allowed the remaining entities in the sector to focus on reducing non value adding activities and using innovation to build a sustainable future.
- Reduced development and production cycles, a need to shorten the supply chain and a move away from broad based fashion to individualism are putting substantial pressure on the manufacturing and design sectors of the industry. The difficulties incurred by the low wage production centres in meeting these demands has allowed our higher wage production centres to compete on quality, cost and lead time. Australian manufacturing cannot compete with the low cost production centres in large runs, however the percentage of business centred on small runs and numerous colour ways is requiring a faster and more flexible service than can be provided by the low cost centres.
- Constant geographical movement in the high labour, low capital sectors has caused significant problems for high capital intensive sectors. Companies that have moved into low labour cost areas with capital intensive programs have been faced with high infrastructure costs, increased labour costs and increase indirect taxation.
- The need for low cost centres to conform to global industry standards of occupational health and safety, and environmental standards is starting to bring infrastructure costs into comparison.
- The major difficulty faced by the sector in recent times has been the need to differentiate between marketing and manufacturing. Those entities that have chosen the marketing route have been faced with increased pressure from retailers for higher margins, and increased pressure from the major brands in terms of shelf space and price points. The result is that brands are either successful or they fail, there is no middle ground.
  The manufacturers have found an ever decreasing customer base. As the intermediate brands disappear, manufacturers must align themselves with a major brand or be squeezed by price constraints by the generic brands of the retailers.
- A major impediment to international market competition is the perception that a flexible well managed high quality niche manufacturing business cannot be run out of Australia. In order to develop the required relationships with major brands and retailers there has to be a belief in the ability of the supplier to attain the required levels of quality, cost, lead time and innovation. The persistent feedback from Australia is that they do not want “sunset” industry.

Therefore there is a perception from international customers that such entities cannot survive in an unwanted environment.

- Success factors are: Combined focus, good management, above average utilisation of capital, a focused and specific development strategy leading to a narrow well defined product range. While brand recognition, marketing and design are important, a well balanced management team offering entrepreneurial, administrative and technical skills is the single most important success factor.
- Failures have been driven by: Lack of a balance between entrepreneurial, administrative and technical skills. The notion that manufacturing is easy in low cost countries without infrastructure, where the language and culture are different. A lack of strategic vision for the future resulting in a strategy of attempting to maintain a status quo that has resulted in industry failure.
- Australia has a major competitive advantage in the following areas: Infrastructure, political stability, and resources both human and material. Any industry that can use these advantages will be competitive.
- The strength of the advantages will change as the economic conditions change. The eighties was an era of greed that ended in major collapses. The nineties was an era of speculation based on the advent of new tools. This decade will bring a resurgence of the “grunt” economy. Investors are wary of industries that produce paper money. IT is being seen for what it is, a tool to increase productivity in the grunt economy. Capital will become scarce as low interest returns on government bonds are preferred to the high risk nature of the stock market. This leads to an increase in interest rates especially for risk capital. Major capital resources, superannuation funds, were used as risk capital in the last two decades. The future will bring risk aversion. Two money markets will emerge. The steady market where interest rates will remain at lower levels and the risk market where interest rates will increase. The more productive use of capital will become the major driver for manufacturing and the shortening of the distribution chain. This will increase the ability of Australian manufacturers to supply the modified needs of their major customers. It really does not matter how low the price is if it is not on the shelf on time.
- The question should be. How will we measure productivity? While leadtime and quality have been talked about, the focus has been on price. The changing market towards diversified product, shorter leadtimes and the need for innovation will see the definition of productivity changing. An average TCF supply chain cost break up is roughly. 20% to the manufacturer. 20% to the brand. 5% for distribution and 55% for the retailer. When labour represents 10% of the production cost or 2% of the retail price what importance should be placed on the labour cost during manufacturing? Productivity will become a measurement for the total supply chain and not just for the manufacturing cost. The focus for the development and manufacturing will change from strictly cost to time. In this area Australian firms with the human and material resources at hand will have a distinct

competitive advantage over difficult to get to low labour cost competitors.

- Future performance will be influence by:
  - Cultural perceptions about Australian manufacturing from within Australia and from our international customers.
  - Exchange rates are less of an influence where capital and raw material are traded on the same global stage as the finished article.
  - Microeconomic reform and the tax system are a major cost constraint on Australian business. Administrative costs to deal with demands for information and permits are a major consideration.
  - Trade barriers restrict the growth into niche markets. While success can be enjoyed in one market it is often difficult to grow that success because of the trade barriers that appear to be escalating rather than declining.
  - TCF&L industries face competition from competitors that are assisted.
- The taxation system has slowly clawed away needed capital for growth. Experience has shown that smaller companies do better in the TCF&L industries. These companies do not have the critical mass to set up global enterprises so as to make use of lower tax regimes. Therefore the backbone of the TCF&L industries has needed to take on a greater share of the tax burden both from the federal and state governments. With the larger companies paying tax offshore and the retraction of the tax base against the need of government, the tax burden on SME's has increased.
- International competitors in low labour cost countries use low tax regimes to build up the capital required to build and grow their businesses. Australian based enterprises find that the majority of their growth funds are taken away in taxes. This slows growth and results in alternative uses for capital.

Impact of Current Assistance Arrangements.

Tariffs on competing imports.

These are an absolute necessity in order to level the playing field. Competitors from other countries operate under completely different social, economic and environmental frameworks. There cannot be commercial rewards for the abuse of human rights, operation under low tax regimes and degradation of our global environment. The purchase of goods produced under conditions not tolerated in this country is simply the exportation of human misery, pollution and our value systems.
Logic says that corporate entities that do not pay tax, abuse human rights and pollute the environment will be more competitive.

The alternative to tariffs is the removal of the grunt economy from the Australian economy. Recent research by the Institute for Supply Management™ in the US shows what happens in a service driven economy. Tariffs make some way toward levelling a very unlevel playing field.

Strategic Investment Program.

The SIP Scheme rewards risk capital directed toward innovation and new equipment. In relation to innovation the scheme is efficient and effective. It delivers to companies the ability to fund innovative activities, while at the same time imposing a disciplined approach previously not the industry norm. In relation to capital expenditure it is based on a number of principles that create inefficiency in the commercial environment. The utilisation of capital is increasingly important. Buying the latest technology is not necessarily the most efficient solution. As stated above the future will be in short lead times. This requires quick changeovers. The latest technology is normally geared towards the larger runs. Why purchase the latest and the greatest with its risk factor?

The building of new buildings may help the overall economy in the short term, but why build new buildings when the country's resources are already dramatically under utilised.

Growth comes most efficiently when market success is matched by production resources. Waiting for new equipment will often mean missing a market opportunity.

Generally available government programs.

The majority of these programs lead to increased overhead structures. The vast bulk of the TCF&L sector does not have the ability to access resources that make the majority of programs viable. A critical strategy for the sector must be to maintain a low overhead structure. The utilisation of resources through good management is a necessity.

The mode of operation is moving toward the maintenance of customers through the development of relationships. The Pareto principle is being applied to customers. Each year the 80% of non performers needs to be culled. This strategy leads to building on established markets. This requires substantial funding and normally comes at a time when the ability to gain assistance through the EMDG has expired.

Impacts of assistance.

- The desirable change has been that growing profitable businesses have been able to use the grants to pay their tax bill in order to increase the capital employed in the entity. At the same time the SIP Scheme has increased professional behaviour and dictated disciplines.
- The undesirable side effect has been that inefficient entities have been encouraged to persist with failed strategies.
- The SIP Scheme has allowed entities to take some risks that they otherwise would not have taken.

- The insistence that only new plant or buildings be eligible for Type 1 grants is a deficiency. The objective is to prepare companies for 2005. That means maximum utilisation of capital and technology. A new building at a new site is contrary to good planning when an existing building next door is available. A used machine that fits a purpose is preferable to a new machine which would substantially over capitalise the company.
- Global business today excludes the concept of a developed market. The time frames for the EMDG are not practical anymore. A focus is required on keeping the good customers not using the marketing shot gun.
- Being in the manufacturing sector requires a constant focus on innovation, process improvement and productivity increases. Manufacturers in the TCF sector see the present tariffs as a mechanism in order to level the playing field. Free trade with competition that uses non tariff trade barriers, dumping mechanisms, quotas and tariffs is simply not an option. It is not about taking advantage of the pause, it is about waiting for the country to realise that it needs a manufacturing economy. In the US the service sector has had 13 months of increase in a row, yet the economy is still considered to be down. The service sector comprises 75% of the US economy, and the economy cannot grow without growth in the manufacturing sector. The US has recognised that without strong growth in the manufacturing sector there can be no future in the service sector. Hence recent decisions by the US to support its agricultural sector and manufacturing sector.
- Costs to consumers. The SIP Scheme has not contributed to any costs to the consumer.
- Costs to the Taxpayer. Given the generation of jobs direct and indirect, PAYG tax, payroll tax, GST, and local taxes, there is no cost to the taxpayer.
- Cost to other industry. The SIP Scheme has promoted the supply and building industries.

Market Access Issues.

It is essential that further reductions in TCF&L assistance should not be contemplated until significant market access gains have been achieved in major markets throughout the world and particularly in Asia.

Signatories.

PDR Sport Pty. Ltd.
Vacel Leather Pty. Ltd.
Angus Clyne Pty. Ltd.
Color-Rite Australia. Pty. Ltd.