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Overview

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| Key points |
| * Government assistance to industry is provided through an array of measures including tariffs, budgetary outlays, tax concessions, and restrictions on competition. * This benefits the industry receiving it, but comes at a cost to other industries, taxpayers or consumers. A critical issue is whether the benefits accruing to industry outweigh the costs. * Estimated tariff assistance to industry was $7.8 billion in 2012‑13 in gross terms, accruing overwhelmingly to manufacturing. Budget and tax related support was worth a further $7.8 billion, thus total gross assistance was $15.6 billion. * After deducting the cost penalty of tariffs on imported inputs ($7.1 billion, two thirds incurred by services industries) net assistance to industry was $8.5 billion. * Budgetary assistance in 2012‑13 was about $2.2 billion less than in 2011‑12. The largest reductions were from the winding down of transitional assistance afforded by the Energy Security Fund ($1 billion), the Coal Sector Jobs Package ($219 million) and the Steel Transformation Plan ($164 million). * Since November 2013, the current Government has announced, amongst other things, that it would: * reduce funding to motor vehicle manufacturing between 2015–2017 by $500 million, not provide a debt guarantee or line of credit to Qantas, nor provide assistance requested by processing company SPC Ardmona, but would proceed with support to Cadbury for a tourist facility. * Australia recently agreed to bilateral trade agreements with Korea and Japan. Trade agreements can distort comparative advantage between nations and consequently reduce efficient resource allocation. * The rules of origin in Australia’s nine bilateral agreements differ widely, are likely to impede competition and add to the compliance costs of firms engaging in trade. * Government outlays on defence capability represent one of the largest discretionary items in the Commonwealth’s budget. * Defence industry assistance includes cost premiums for local purchasing preferences and budgetary support for skilling, research and exporting (with expenditures up to $500 million directly and indirectly benefiting industry). * Significant cost premiums can also be incurred by choosing to modify off-the-shelf equipment or pursuing bespoke designs. * To be justified, cost premiums and defence industry assistance need to be commensurate with any additional security and operational benefits. Publishing these additional costs and benefits would assist understanding of apparently huge cost differentials. * The efficiency and effectiveness of direct defence industry assistance programs could benefit from independent scrutiny. * Three short reviews also comment on topical areas of public interest: R&D; Foreign Investment Rules; and Special Economic Zones. |
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# Overview

The Australian Government assists industries through an array of measures, including import tariffs, budgetary outlays, taxation concessions, regulatory restrictions on competition, and government purchasing arrangements. Although assistance generally benefits the receiving industry and businesses, it penalises other industries, taxpayers or consumers. Transparency about assistance arrangements is therefore important.

This *Review* reports the Commission’s latest estimates of assistance to industry, up to 30 June 2013. More recent announcements relating to industry assistance, including trade policy developments, have also been reported. The Commission has also included a chapter about assistance to the defence industry and shorter discussions on government support for business R&D, foreign investment rules and special economic zones.

Assessing whether the benefits of any particular support program exceed the costs requires detailed consideration — a task which is not the focus of this *Review*.

### Estimates of assistance to industry

Australian Government assistance to industry amounted to over $15.6 billion in gross terms in 2012‑13 — comprising $7.8 billion in gross tariff assistance, $4.4 billion of budgetary outlays and $3.4 billion in tax concessions.

After allowing for the cost to business of tariffs on imported inputs ($7.1 billion), estimated net assistance across all sectors was $8.5 billion in 2012‑13.

The sectoral incidence of tariff assistance, budgetary support and the input penalty of tariffs is markedly different (figure 1). Most notably, the manufacturing sector receives the highest level of net assistance — mainly because of tariff assistance on its outputs. In contrast, the service sector incurs around two thirds of the tariff penalty on inputs and negative net assistance overall.

Figure 1 The incidence of assistance varies widely between industries, 2012‑13

$ billion (nominal)

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The estimated value of budgetary assistance amounted to $7.8 billion (outlays plus tax concessions) in 2012‑13, down from around $10 billion the previous year (figure 2). The largest reductions were from the winding down of transitional assistance afforded by the Energy Security Fund ($1 billion), Coal Sector Jobs Package ($219 million) and Steel Transformation Plan ($164 million) — all introduced to assist with the transformational implications of the carbon pricing mechanism. The level of budgetary support to rural industries in 2012‑13 declined from earlier years mainly because of lower taxation concessions under the Farm Management Deposits Scheme ($80 million) and lower Exceptional Circumstances (interest rate) payments ($32 million).

Figure 2 Budgetary assistance to industry declined in 2012‑13

$ billion (nominal)

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The effective rate of assistance — net assistance per unit of value added — was around 4 per cent for the manufacturing sector, over 2 per cent for the primary production sector and less than 1 per cent for mining. At the industry group level, the highest measured effective rates of assistance continued to be for the motor vehicles and textiles, clothing and footwear industries. With the scheduled reduction in tariffs on selected textile and clothing items on 1 January 2015, net assistance to these activities will decline further. Net assistance to the automotive industry will also decline with scheduled reductions in industry-specific budgetary support, although with the tariffs remaining in place, under current settings, the tariff penalty on imported vehicles will remain.

In dollar terms, the highest net assistance was afforded to the metal products and food processing industries — mainly on account of the 5 per cent general tariff on a range of products manufactured by these industries (figure 3).

Figure 3 The level of assistance afforded to manufacturing industries varies, 2012‑13

$ billion (nominal)

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While effective rates of assistance have not been estimated for the service industries, net assistance in dollar terms is negative for most service industries because the tariff penalty on inputs exceeds the magnitude of any budgetary assistance.

While present effective rates are historically low, the effective assistance for an individual company or project can be quite significant. For example, a number of industry grant programs to both goods producing and service activities provide subsidy equivalents for supported projects well above industry averages. This can be quite distortionary, within an industry as well as at the economy-wide level.

### Recent industry assistance related announcements

Since May 2013 (the reporting date for the 2011‑12 *Review*), the current and previous Australian Governments announced a number of budgetary and regulatory measures relating to industry assistance, across a wide range of activities.

Some significant new support programs were announced by the previous government including a $400 million Regional Australia’s Renewables initiative, the $10 billion Clean Energy Finance Corporation, and two Innovation and Investment Funds (Melbourne North and Geelong) — these measures remain in place.

The current government announced a $100 million economic growth plan for Tasmania (which supersedes the previous government’s $100 million Tasmanian Jobs and Growth Plan) and its intention to close the Clean Energy Finance Corporation. Amongst other things, it also announced: industry-specific budgetary assistance to passenger motor vehicles manufacturing would be scaled back by $500 million; that it would not be providing the $25 million assistance requested by fruit processing company SPC Ardmona; nor would it be providing a $3 billion debt guarantee or line of credit to Qantas; and that it will develop a $155 million growth fund intended ‘to support economically responsible initiatives in regions facing pressure in their manufacturing sectors’. T**he Government intends to proceed with an election commitment to provide $16 million to Cadbury, mostly for its tourist facility**.

The Government asked the Productivity Commission to undertake inquiries into Tasmanian shipping and freight and Australia’s automotive manufacturing industry. The final reports of the Tasmanian shipping and freight inquiry and the automotive manufacturing industry inquiry were sent to the Government on 7 and 31 March, respectively.

### Recent trade policy developments

Trade policy can remove barriers to trade or it can rearrange them. In some instances, the changes can provide assistance to activities or industries and substantially distort efficient resource allocation.

The 9th Ministerial Conference meeting of the WTO’s Doha Round of multilateral trade negotiations was held in Bali, Indonesia from 3 to 6 December 2013. The meeting focused on reaching agreement on matters that would constitute a first step toward concluding the Doha Round launched in 2001. Progress with Doha Round negotiations had stalled up until this meeting and expectations for outcomes in Bali were low. Three main issues were discussed at the Bali Conference — trade facilitation, agricultural reform and developing country initiatives. In spite of the reservations that preceded the meeting, the conference was viewed as a success with the agreement on trade facilitation being referred to as a stepping stone to the completion of the Doha Round. On the remaining matters, it was agreed that outcomes would be progressed through increased transparency, ongoing dialogue, monitoring and review.

In parallel with Doha Round negotiations, national economies have continued to negotiate and enter into bilateral and regional preferential trade agreements. By the end of 2013, the number of preferential trade agreements in force in the Asia-Pacific region had risen to 157, accounting for over 40 per cent of global agreements registered with the WTO. Australia signed a bilateral trade agreement with Korea and concluded negotiations on an economic partnership agreement with Japan. Australia also has trade agreements currently in force with New Zealand (in force since 1983), Singapore (2003), Thailand (2005), the United States (2005), Chile (2009), ASEAN and New Zealand (2010) and Malaysia (2013) and is negotiating agreements with a number of other countries including China, India and Indonesia.

Negotiations also continued on the proposed Trans-Pacific Partnership and the Regional Comprehensive Economic Partnership. The two regional agreements, if formed to include the current negotiating parties, would constitute two discriminatory trading blocs with limited overlap in member-to-member trade.

In its 2010 report into bilateral and regional trade agreements, the Commission concluded that increases, if any, in net national income accruing from preferential agreements are likely to be modest. The Commission also concluded that current processes for assessing bilateral and regional agreements lacked transparency and tended to oversell the likely economic benefits. To help ensure that bilateral and regional trade agreements entered into are in Australia’s best interests, it recommended that a full and public assessment of a proposed agreement should be made after negotiations have concluded. Such an evaluation would cover all of the actual negotiated provisions.

A key feature of preferential trade agreements is the rules of origin that determine whether a specific product is eligible for preferential market access. The rules of origin in each of Australia’s bilateral agreements have their own requirements that are subject to detailed negotiations in their formation (figure 4). As a consequence, there is considerable variation in the way origin rules are structured between agreements, adding to complexity. Such complexity adds to the compliance costs for firms engaging in trade. The origin requirements and the complexity of the rules are likely to impede competition.

Figure 4 The structure of rules of origin varies substantially between preferential trade agreementsa,b

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| Rule for determining origin  Per cent of listed rulesc | Application of the CTC method  Per cent of listed CTC rulesc |
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a ‘CTC’ refers to a change in tariff classification test. ‘RVC’ refers to a regional value content rule. ‘Other’ includes, for example, combined CTC and RVC rules, CTC rules with exceptions and specified process tests that require particular production methods to be used to qualify for preferential entry. b The agreement with Singapore is not included as it applies a single three-tiered test of origin based on location of production and, for manufactured goods, an RVC requirement. c Individual rules can be expressed at the 4 digit heading level, the 6 digit sub-heading level or for groupings of tariff line items. The number of listed rules therefore differs between agreements.

While effort could be committed to simplifying and unifying rules of origin across agreements, the simplest and most beneficial approach to addressing *inter alia* rules of origin would be to unilaterally reduce tariff barriers on a most favoured nation basis, thereby eliminating altogether the need for preferential rules of origin on imports.

### Assistance to the Defence industry

By varying the size, nature and timing of local defence purchases, Government significantly shapes the defence industry and the location of its activities.

Defence industry assistance comes in a number of forms including cost premiums for local purchasing preferences as well as budgetary support for skilling, research and exporting.

The current Australian Industry Capability program potentially leverages work for local suppliers by including in tender requirements a definition that, for tenders to represent value for money, tenderers must describe how their proposed approach will enhance domestic defence industry capabilities. The ‘Defence Capabilities’ are a set of 24 pre-determined activities that must be resident within Australia or enhance self‑reliance. The industry capability program evolved out of earlier schemes from the 1970s and 1980s that mandated both explicit levels of local activity (such as requiring local work for Australian industry of 30 per cent of the value of foreign contracts, though not necessarily tied to the actual purchase) and preference margins for local bids (such as tolerance of a 20 per cent cost premium).

Significant cost premiums can also be incurred by choosing to modify off-the-shelf equipment or pursuing bespoke designs. A key policy question is whether the magnitude of *additional* costs (that is, the premium) associated with domestic supply and/or enhanced design is commensurate with any *additional* capability benefits.

Such a comparative analysis contrasts with common but misleading gross multiplier analysis. Such multiplier analysis most often fails to take into account constraints on the availability of land, labour and capital and the productive efficiency with which those resources are used — compared to their alternative use. For large defence projects, these considerations are of national as well as industry and regional consequence. Moreover, the costs of financing the premium (whether the costs are in the form of reduced expenditure on other public services, increased taxes, or higher debt) must be taken into account. These opportunity costs have (negative) multiplier (flow-on effects) themselves.

Given the potential cost from eschewing off-the-shelf options to pursue a local (or overseas) developmental or bespoke design, previous reviews have recommended that Defence purchasing submissions to Government include adequate advice on off‑the‑shelf options. However, the Australian National Audit Office recently concluded that such action has yet to be achieved in all cases. At present, there is no mechanism to ensure compliance with this requirement, other than the Government insisting on ‘adequate’ advice. To justify the difference and to encourage an appropriate analytical approach to such large discretionary spending, the estimated premium (for non-off-the-shelf and local build choices) could be made public soon after the Government procurement decision.

Australian based suppliers of defence equipment also benefit directly from grants for technology development, grants for skill development, export marketing and promotion on behalf of industry, government conducted R&D, and small and medium sized business development services. In 2012‑13, identifiable program expenditures, including direct support to industry and public R&D that may indirectly benefit industry, were of the order of $500 million. However, there are some industry assistance programs for which expenditure is unable to be identified as the program cost forms part of the broader budget of the Defence Materiel Organisation. Defence industry programs also do not appear to have been (externally) evaluated within an economy-wide framework to the same extent as ‘mainstream’ industry assistance programs. To the extent that they have not faced such scrutiny, there would be merit in reviewing the efficiency and effectiveness of the suite of defence grant, industry engagement and research programs.

### Some other government interventions warranting closer examination

This *Review* also discusses selected areas of government intervention and industry support that may be limiting Australia’s productive potential.

#### Public support for business research and development

Public support for business R&D under current arrangements has been found to have a relatively low inducement rate. This suggests that consideration of more cost-effective means of allocating available innovation funding to business is warranted. This could entail modifications to the design of the current arrangements such as using an historical R&D to sales ratio or average R&D spend as a base against which genuinely additional R&D can be compared. Simply reducing company tax by an amount equivalent to current concessions could provide a sound alternative benchmark for analysing the relative merits of R&D concessions.

#### Regulation of foreign investment

Foreign investment is an important source of finance for new investment and income growth in Australia. At the same time, there is sensitivity surrounding direct foreign investment, particularly when it is directed at sensitive or strategic activities, with such flows subject to regulation under the Foreign Acquisitions and Takeovers Act 1975 and activity or sector-specific regulation. Recognising the costs and benefits of foreign investment, there may be merit in examining the stringency of the foreign investment review process and national interest criteria. There would also be merit in considering the application of the same notification threshold to all countries in accordance with the MFN principle.

#### Public support for regional development and special economic zones

Special economic zones can be pursued to selectively benefit activities within a designated area. A number of Asian economies have recently adopted such policies to trial structural reforms. Similar measures have been used in Australia for regional development purposes and more might be considered in future. There would be merit in clearly assessing whether such measures are likely to confer community‑wide benefits and whether less discriminatory measures would be preferable.