PRODUCTIVITY COMMISSION INQUIRY

REVIEW OF AUSTRALIA'S GENERAL TARIFF ARRANGEMENTS

Submission on behalf of

Digital Audio Technologies Australia

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PRODUCTIVITY COMMISSION INQUIRY – REVIEW OF AUSTRALIA'S GENERAL TARIFF ARRANGEMENTS

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2. Requests

(a) that the general tariff rate of 5% be retained at the present level until 31 December 2005, and then phased down at the rate of one percentage point per annum until zero is achieved in 2010 pursuant to Australia's APEC commitments.

(b) that the 3% revenue levy on business inputs otherwise entitled to entry under Item 50 Tariff Concession Orders (TCOs) be abolished upon implementation of the Commission's recommendations.

(c) that the Tariff Concession system be retained until such time as it becomes redundant.

(d) that the criteria for the Tariff Concession System be amended to permit the entry free of duty of any goods in respect of which local industry does not manufacture an alternative that would be regarded as directly substitutable in either conditions of perfect competition or conditions of imperfect competition (as those concepts are understood by economists).

(e) that the policy by-law system be retained to permit the entry free of duty of any goods, not otherwise entitled to entry under Tariff

Concession Orders, where it is considered to be in the national interest for tariffs to be waived, for reasons including but not limited to-

(i) the encouragement of investment in industries which are capable of operation, in the longer term, in an unassisted environment,

(ii) to remove impediments to international competitiveness for export-orientated industries or industries which are significant contributors to export incomes (such as mining and agriculture), and

(iii) the introduction into the Australian economy of capital equipment, intermediate goods and raw materials that incorporate "state of the art" technology or the utilisation of which results in demonstrable improvements in manufacturing capability.

(f) that the criteria to be considered in the utilisation of industry specific policy by-laws be determined by a process of consultation with relevant industry peak councils.

(g) that the processing of applications for policy by-laws be undertaken in a manner that gives full and proper effect to the

beneficial purpose underlying such by-laws, and that processing guidelines are not used to defeat that beneficial purpose.

3. Retention or Abolition of Tariffs ?

The arguments in favour of abolition of tariffs across the board are well known and that position will no doubt be the Commission's preferred option in its recommendations to the Minister in its report on this inquiry.

Although much has been written concerning the benefits of a free trade environment in Industries Assistance Commission and Industry Commission Annual Reports over the past 25 years or so, we believe that what will no doubt be the preferred option was succinctly stated thus by the Industry Commission in its 1994-95 Annual Report-

Should tariff reductions depend on other reforms?

Australia benefits from reducing its industry protection whether or not other countries reciprocate. The Commission has estimated that Australia's decision in March 1991 to reduce protection would result ultimately in a permanent increase in GDP in the order of 0.4 per cent, or some $1.7 billion.

Action by other countries to reduce their trade barriers can add to these gains and international commitments can help to lock in domestic reforms. However, this is not a reason for Australia to move away form the unilateral approach it has adopted to assistance reductions. Deferral of assistance to some industries until progress is made on reducing assistance in other countries would continue to impose costs on Australian consumers and on more efficient Australian industries as they attempt to adjust to an increasingly competitive international marketplace.

Some argue that in proceeding unilaterally Australia nevertheless squanders negotiating coin that it could use in bargaining with other countries to reduce their trade barriers. It is conceivable that negotiated outcomes can produce a better result, but in Australia's case the evidence strongly supports not waiting for other countries to act. The fact is that Australia has been granted concession is multilateral negotiations for lowering its trade barriers unilaterally. Moreover, the experience has been that small and medium-sized trading nations possess limited bargaining power. Unilateral action by Australia can, however, have a demonstration effect on other countries. It has been observed that Australia's trade policies over the past few years have contributed significantly to preserving the integrity of the multilateral trading system and have set an example for others to follow (GATT 1994d, p.5).

> *Another argument is that assistance reductions for domestic industries should be deferred pending faster progress on other elements of microeconomic reform in Australia. The Commission's work shows that the benefits of tackling a number of elements together can be mutually reinforcing and can help to ease adjustment difficulties. Each domestic reform, however, has its own pay-off. Moreover, reform in one area can drive reforms in other areas. Tariff reductions have been a particularly important driver of productivity improvements in Australia as previously protected industries have sought to have their input and other costs reduced. If every sector of the economy were to succeed in having reform in its area conditional on reform elsewhere, the whole process of harnessing competition to raise productivity could stall.*
> (IAC Annual Report 1994-95 p.19)

The Commission estimated that tariff protection for the manufacturing sector would cost consumers around $4.0 billion at the end of the 1996 tariff reduction programme. However, that figure includes the cost to consumers of protection for the PMV and TCF industries. The cost of protection for manufacturing activity outside the highly assisted sectors would have been much less.

This brings us to the issue which we ask receives the careful consideration of the Commission pursuant to item 4(h) of the terms of reference for this inquiry.

We are aware that the cost to consumers of tariff protection for manufacturing industry is measured by gross and nett subsidy equivalents, defined in the 1973-74 IAC Annual Report (p.54) as follows –

- The *gross subsidy equivalent* is the amount of money which would be necessary to provide the same amount of assistance by subsidy as is provided by an industry's nominal rate

- The *nett subsidy equivalent* is the amount of money which would be necessary to provide the same amount of assistance by subsidy as provided by an industry's effective rate. It is equal to the gross subsidy equivalent less the tax equivalent of protection to materials used.

Our recollection is that gross and nett subsidy equivalents were quantified by reference to actual published ABS duty collection data (from Table MC01 - Imports Cleared for Home Consumption) and application of the effective rate formula from the Tariff Board's 1966-67 Annual Report pp.32-36. The cost to the community was therefore relatively easy to quantify by this process. We understand also that

this formula approach was incorporated in the ORANI model used by the Commission for many years to measure the cost to the community of tariff protection and the measurable effects of variations in the level of assistance afforded by tariffs and similar taxes or subsidies (including bounties).

We have some doubts about whether this arithmetical exercise ever told the whole story, particularly in relation to industries based in small to medium sized communities.

We can recall for example that one measure (at least from an arithmetical perspective) of the cost to the community of tariff assistance was to divide the gross subsidy equivalent amount by the number of persons employed in the industry under examination, and to then postulate that the answer to that sum was the cost to the community of providing a job in that industry.

We can recall also confident assertions in industry-specific inquiries up to about 10 years ago that "labour resources" displaced by reductions in assistance measures could be taken up elsewhere in an expanding economy. (The truth is of course that unemployment grew from the mid-1980's to about 2 years ago, and jobs in the manufacturing sector have declined significantly over that same period).

We think it was often the case that the true cost to the community of assistance reduction was not measured. For example, capital equipment utilised in an industry that ceased to be viable because of a removal or reduction in tariff assistance (such as the printing machinery industry) was not available for redeployment but simply became scrap and therefore represented a depletion of the economy's capital assets. Displaced "labour resources", particularly those in small or regional communities, were never as mobile as the Commission appeared to believe and simply became a cost to the community through a need for public support (welfare). Loss of employment in those circumstances also resulted in loss of tax revenue from wages and general diminution in the value of the community's assets through, for example, reduction in house prices and the closure of businesses dependent on the fact of employment levels in a community not falling below the level necessary to sustain the community as a whole. These things were also part of the cost of reducing industry assistance, but we cannot recall much debate on them, probably because they only ever needed to be considered in an industry-specific context.

That is not the case in this inquiry and we trust that the Commission will give this important issue the attention it requires.

One other matter requiring some consideration is the fact that a 5% general tariff rate probably represents a nominal rate today of between 4.0 and 4.5 per cent, and provides an effective rate (for assisted

industries) of less than 8 percent on the value-added processes. (For industries such as the recording industry, tariffs on inputs and zero assistance on output provides negative assistance – Industry Commission Report No.49 on Packaging and Labelling pp.58-60. The mining industry is similarly adversely affected).

It has been our experience over the past few years that, as tariffs have reduced, gross margins on cost and nett operating profits before tax have also reduced. In some industries having tariffs on manufacturing inputs and zero assistance on output, the tax effect of those tariffs can equate up to 40% of the nett operating profit before tax of the industry as a whole. Whilst that may be seen as an argument in favour of abolishing tariffs across the board (as the Industry Commission noted in its Packaging and Labelling Report), we seriously doubt that a nett benefit to the economy as a whole can result from abolition of tariffs across the board because such an outcome could not be predicted with any certainty unless the following likely effects were also quantified –

(a) extent of loss of employment resulting from abolition of tariffs

(b) cost to community of scrapping of capital assets not deployed elsewhere

(c) cost of welfare for displaced labour resources not able to be taken up elsewhere in the economy

(d) loss of tax revenue from wages

(e) diminution in value of community assets

(f) social impact on small and medium-sized communities.

It should be noted also that the imposition of tariffs on imports, in the form of revenue levies on free goods, has been a useful source of revenue over the past 20 years for Governments wishing to find an easy mechanism for the reduction of budget deficits. Reduction of tariffs to zero, accompanied by a commitment under external trade agreements not to increase or impose tariffs once bound at that level, will deprive the Government of a useful revenue tool.

Our final note is that, if the general tariff rate is maintained at 5%, the nominal rate for assisted industries is going to be no more than 4.5%. Although the effective rate for industries having zero taxes on inputs and assistance on outputs with low value added will be much higher (at least arithmetically), the reality of the situation is that the ex factory price of the output of assisted industries isn't going to be much more than about 4% above world prices.

The Australian community might believe that this is a price worth paying to maintain employment and investment in manufacturing activity in this country.

4. Tariff Concessions

We request that the Tariff Concession system be retained in the event that the 5% General Tariff rate is retained.

A Tariff Concession system allowing the entry free of duty of inputs to manufacturing will assist in reducing the ex factory price of manufacturing industry output to level closer to world prices.

Further, for those industries which have no assistance provided for their output but pay tariffs on their inputs (such as the recording industry), access to inputs at world prices will enable them to compete more effectively against imports in their domestic market.

We accept that maintenance of a 5% general tariff rate for five years, phasing down to zero in 2010 as required by our APEC commitments, will continue to provide some small scope for Australian manufacturing to maintain ex factory prices slightly above world prices, and thus provide some measure of "protection" from import competition. However, such a tariff is plainly a cost to the community where there is no local industry to protect and a concessional entry system of some kind will provide relief from tax on imported goods where an intended "protective" effect is unnecessary.

There have been several attempts over the past 15 years or so to define the circumstances in which relief from customs duty can be obtained under general concessional provisions. Perhaps the best of these was the legislation enacted in 1985 to provide relief from customs duty in all circumstances other than those in which it was established that local industry manufactured "identical" goods (i.e., those that were substitutable in conditions of perfect competition) or "similar" goods (I.e., those that were substitutable in conditions of imperfect competition). Unfortunately, it appears that those responsible for administration of the legislation did not have an adequate grasp of the economic principles the legislation sought to give effect to, and the legislation was not well administered.

Litigation relating to interpretation of that legislation also produced unsatisfactory outcomes, as it appears that the Administrative Appeals Tribunal and courts also had some difficulty in grasping the principles underlying the legislation. We do not believe that the Commission should be deterred by these setbacks however.

If the Commission recommends that retention of a Tariff Concession system to provide general duty relief should be retained, we request that the perfect and imperfect competition analogies be recommended, and that any enabling legislation drafted to give effect to such a recommendation be drafted in consultation with lawyers who understand the economic principles involved.

5. Policy By-Law System

From mid 1989 onwards, the then Federal Government enacted a series of items in Schedule 4 to the *Customs Tariff Act* 1987 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 ("TCOs"). Those items taken collectively make up what is generally referred to as the policy by-law system ("PBL system").

It is important to an understanding of the purpose of the PBL system to recognise that, at the time of its introduction, the Tariff Concession legislation permitted the entry of imported goods free of customs duty in either of two sets of circumstances, viz-

- where there was no manufacture in Australia of substitutable goods, and

- where there was manufacture in Australia of substitutable goods but the making of a TCO for the imported goods would not have a significant adverse effect on the market in Australia for the substitutable goods.

It followed therefore that 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.

Although neither the Industry Department nor the Australian Customs Service ("ACS") had any difficulty with these fundamental principles up to November 1994, it is fair to say that, since that time, the PBL system has been administered so poorly that it is no longer capable of giving effect to its underlying beneficial purpose. (We will illustrate these failings with some specific references later in this submission).

At this point however, we request that the Commission recommend retention of the PBL system as an instrument of industry-specific assistance policy, irrespective of whether a Tariff Concession system is retained to operate in parallel.

We further request that the original principles underlying the PBL system be reintroduced and given proper effect according to that beneficial intent.

We make the following observations in respect of certain aspects of current administration of the PBL system to illustrate its failings.

1. **Item 43 - Components of Functional Units**

An administrative practice was developed in 1984 by the ACS which allowed large items of equipment, which were required to be disassembled for transportation purposes, to be entered under a single classification at the time of importation into Australia, irrespective of the number of shipments required to deliver the goods. That administrative practice was outlined in the notes which formed part of the preamble to the working edition of the Customs Tariff, and was given legislative effect in 1988 when enacted as Item 43 in Schedule 4. A standing by-law was published reflecting the terms of the previous administrative practice. That standing by-law exists today.

In 1989 however, following its consideration of Industries Assistance Commission Report No.413 into the Mining, Construction and Agricultural Industries, the then Federal Government decided to abolish tariffs on capital equipment used in the mining and agricultural industries, notwithstanding that there were well-established industries in Australia manufacturing such goods.

The Government's reasoning was that, since the mining and agricultural industries collectively contributed over 70% of national export earnings AND were required to compete in world markets at world prices, the imposition of taxes in the form of tariffs on inputs represented a major impediment to cost effectiveness for those industries. The abolition of tariffs was intended to

ensure that the mining and agricultural industry users of capital equipment gained access in the future to their equipment requirements at world prices.

To ensure however that the local capital equipment manufacturers were not adversely affected by the decision to abolish assistance on their output, Cabinet decided that Item 43 would be utilised to enable the local equipment manufacturers to continue their production operations.

We can refer to the longwall mining machinery as an example of how Item 43 maintained one of the industries affected by the abolition of tariffs. There were about eight manufacturers of longwall mining machinery in Australia in 1989, supplying a market having a demand of between $300 million and $600 million per annum and employing several thousand people in manufacturing, maintenance and supply activities.

It should be noted that no one single longwall equipment manufacturer at that time had the capability to supply a complete longwall system, because manufacture of components tended to be specialised. For example, shearers were manufactured in Newcastle, NSW by Anderson Rea Pty Ltd, in Moss Vale, NSW by Joy Mining Machinery and in Camden, NSW by Westfalia Pty Ltd. Armoured face conveyors were manufactured in Wollongong, NSW by Meco Australia Pty Ltd and in Rooty Hill, NSW by Halbach & Braun Aust Pty Ltd. Roof support systems were manufactured by Meco and by Westfalia. A small number of parts for these major components were entitled to free entry at the time under TCOs.

A typical longwall system might sell for between $20 million and $60 million and there was a very high degree of compatibility between goods produced by the different manufacturers. It was not at all unusual for a mining company to call tenders for the supply of a longwall mining system, and to let the tenders to two or three manufacturers with each having responsibility for supply of part only of the complete system.

It often happened that time constraints on delivery, or specifications tailored to take account of unusual geological conditions, meant that a local producer could not supply all of the major components of a complete system from local manufacture if awarded a tender, and would be required to import part of it. Item 43 permitted the local manufacturers to bid for complete systems in competition with overseas suppliers, quoting world prices in their tenders. Complete longwall systems could be imported duty free under their substantive classification in the Customs Tariff, but individual components of a longwall system were dutiable at rates ranging from free to 10%. What Item 43 did was to enable local manufacturers to tender for the supply of all components at world prices, because Item 43 permitted the dutiable components of the system to be imported at the rate applicable to the complete system itself, i.e., free.

This ensured that the end users always had access to their capital equipment requirements at world prices, and at the same time ensured that the local manufacturers were not disadvantaged if they had to import some

components for incorporation into a system that was substantially locally manufactured.

Seminars explaining the intended operation of Item 43 for the mining industry were held in 1991 and were attended by representatives of the mining companies and the mining machinery manufacturers. The Item 43 procedure worked extremely well, and the local equipment manufacturers thrived, notwithstanding the loss of tariff assistance on their output. Production costs for coal produced from underground mines were also reduced because all capital equipment was then being purchased at world prices.

About 80 applications for Item 43 determinations were approved between late 1989 and November 1994 for components for longwall mining machines. None have been approved since that time. A letter to this company from the ACS in 1995 stated that it was contrary to Government policy for Item 43 determinations to be issued for such goods.

The last item of longwall mining machinery manufactured in this country was produced in 1996. Of the eight original manufacturers, only three are still in business and their operations today are limited to maintenance activities only. We have been informed in private discussions with senior personnel in the remaining companies that the decision of the ACS in 1995 not to issue Item 43 determinations for components for longwall systems was a principal factor in the decision of each of these companies to cease local manufacture.

One final observation we wish to make in relation to Item 43 and the administration of the PBL system generally is that the comments of Mr Justice Carr of the Federal Court of Australia, in his decision in *BHP Direct Reduced Iron Pty Ltd v Australian Customs Service* (1998) (No. WAG 108 of 1996), are particularly instructive.

2. Item 45 - Capital Equipment for the Mining and Resource Processing Industries

Item 45 was enacted in 1989 contemporaneously with the legislation abolishing tariffs on major items of capital equipment used in the mining industry. The original wording of Item 45 was "Goods designed for use in the mining industry, as prescribed by by-law".

As noted above, the only goods to which item 45 was intended to apply were goods not otherwise entitled to entry free of duty under TCOs or under duty free substantive classifications in the Customs Tariff itself. From the practical perspective, Item 45 applied to two categories of goods-

(1) parts for items of capital equipment which could not be made duty free under substantive classifications (to avoid unnecessary fragmentation of the Customs Tariff itself), and

(2) items of capital equipment imported for utilisation in major projects.

The principal criterion for a concession under category (1) above was that the specific part in question could not be manufactured in Australia. An application for a TCO, and refusal of that TCO, was an essential first step in establishing entitlement to an Item 45 by-law for such parts.

The principal criteria for a concession under category (2) above were as follows –

(a) the project must be of significant benefit to Australia, preferably export-oriented

(b) contracts for supply must be awarded after an open tendering process, and

(c) Australian industry participation must be maximised.

Item 45 was well administered and achieved its intended beneficial objectives up until late 1994. Unfortunately the same cannot be said in relation to that by-law since that time.

The wording of Item 45 was amended in mid-1996 to read "Capital equipment" instead of "Goods". Why that amendment occurred has never

been satisfactorily explained. Most of the items of capital equipment to which Item 45 applies are already entitled to entry free of duty under their substantive tariff classifications.

Repeal of the word "Goods" now means that parts of capital equipment cannot be imported duty free unless they also happen (fortuitously) to be capable of identification as "capital equipment". 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.

To illustrate the absurdity underlying the present administration of Item 45, we offer three from many examples-

(1) a slew ring assembly to be imported shortly by one of our mining industry clients will attract duty at the time of importation. It is to be incorporated into a mechanical shovel which is itself entitled to duty free entry under its substantive tariff classification. The ring cannot be made in Australia. We will be able to obtain a TCO, but the rate will be 3%, not free. Item 45 is not available because total expenditure does not exceed $10.0 million.

(2) an application for an Item 45 project by-law lodged in October 1993 was finalised a few weeks ago and is now subject to litigation. A determination for goods imported in 1995 was refused on the

grounds that the ISO was not involved in the project and the "Goods Advice" describing the goods was lodged after the date of importation. Both of these administrative requirements were introduced after the goods were imported.

(3) almost all of the determinations issued under Item 45 since amendment of the item in 1996 have been for goods which are components of something else. Most applicants are now compelled to go through the pointless and really quite absurd requirement of describing the goods they are importing as items of "capital equipment" despite the fact that, for many of those goods, being described in such a manner often strains credibility. Quite ridiculous outcomes often result also where a major component of an item of capital equipment is imported unassembled over several shipments. Each shipment is considered on its own merits notwithstanding that evidence will be produced that the goods in issue are really an unassembled complete entity being imported as a split consignment. The present administrative approach requires the exclusion from concessional entry of many items which are packed separately for convenience of transportation, notwithstanding that they are integral parts of the component in question.

We seriously doubt that many of these silly and pointless administrative requirements genuinely advance the beneficial purpose of Item 45.

This concessional provision requires a major overhaul, and a return to its original purpose would be a good starting point.

3. Item 57 - Raw Materials and Intermediate Goods

This item permits the entry free of duty of goods falling within certain classifications in the Customs Tariff. The concession applies to goods having a significant and demonstrable performance advantage, in the production of a specific end product, over substitutable goods produced in Australia.

This by-law is particularly important for many industries, including the recording industry. Our submission to the Packaging and Labelling Industries inquiry illustrated one aspect of the importance of this by-law.

We do consider however, that the present administrative guidelines prevent this by-law giving full effect to its intended beneficial purpose.

For example, the present guidelines 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 (pump packaging dispensing metered doses, for example). Tariffs on packaging materials are also a significant impediment to the competitiveness of industries having no assistance on their output (and see particularly pages 58 to 60 of the Packaging and Labelling report). Item 57 will be a ready-made vehicle for elimination of distortions of this kind if the

administrative guidelines (but not the legislation) are changed to permit use for this purpose.

Finally, 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 is not available to permit duty free entry of goods for which local industry does not produce a substitute. This anomaly can be eliminated through the simple expedient of changing the rate of duty under Item 50 (the TCO provision) to Free instead of 3%.