

Is the MIDP a Model for Selective Industrial Policies?

A recent paper (Barnes et al 2003) uses the case of the South African automobile industry to assess the possible role of selective industrial policies in developing countries. It addresses some interesting and very important questions.

It claims to show that South Africa's Motor Industry Development Program (MIDP) has been an economic success and that its underlying principles might serve as a useful model for other sectors and other developing countries. This is consistent with other popular interpretations of the MIDP.

Unfortunately, the conclusions are based on incorrect interpretation of data and on an incomplete understanding of the incentives created by the MIDP.

Following the structure the paper, this commentary addresses the following key issues in the South African automotive industry:

- the success of the motor industry and of the principal policy instrument promoting it in recent years, the MIDP,
- comparative competitiveness indicators in the South African motor vehicle components industry,
- consumer costs and benefits of the MIDP, and
- possible reasons for the success of the MIDP and the associated policy environment.

The Success of the Motor Industry and of the MIDP

The "success" of the motor industry is indicated by the usual indicators touted by DTI and the South African press – growing production, increased foreign investment and above all the recent rapid growth of exports of vehicles and components. It is taken as self evident that growth in these indicators is a sign of economic success.

The description of MIDP is just that, a simple description of some of the main elements; it makes no attempt to analyze the incentives created by the Program. This is unfortunate, since it results in a misleading interpretation of its ultimate effects.

The MIDP is an export subsidy program, with the benefits derived by firms that receive privileges to import components and vehicles on a duty-free basis for the production and sale of vehicles in the protected domestic market. The price that firms are willing to pay to obtain these import privileges provides a lower bound estimate of their value and of the (nominal) protective effect of import duties from which they provide an exemption.¹ Aside from a blanket 27 percent duty-free allowance on components, these privileges can only be obtained, directly or indirectly, by exporting vehicles or components.

While the MIDP incentives are based on selective import duty reductions, they provide substantial protection to sales in the domestic market and give large subsidies to investment and exports. The

¹ The argument in this and the following paragraphs summarizes Flatters 2002.

value of these subsidies rests on rents created by continued import protection for vehicles and components in the domestic market. They gain their effect through transfers from South African vehicle buyers, and they encourage economic inefficiency through high cost production of vehicles and components in South Africa. The direct cost per job created in the motor industry appears to be very high, and the indirect costs to employment in other sectors might also be large.

Table 1 (from Flatters 2002) shows illustrative calculations of effective rates of protection provided to exports of vehicles and of components under one part of the scheme, the Import Rebate Credit Certificates (IRCC) program. The extent of protection provided by the scheme depends on whether import rebate credits are obtained through the export of vehicles or components and on whether the credits are used to import CBU vehicles or components.

Table 1
Effective Protection Given to Exports by IRCC Facility, 2002

Use of IRCCs	Item Exported	
	Vehicles	Components
Vehicle Imports	40%	26%
Components Imports	30%	30%

In addition, a relatively new MIDP feature, the “Productive Asset Allowance” (PAA) grants import duty credits equal to 20 percent of the value of qualifying new capital investments in the sector, with the duty relief spread over a period of 5 years from the date of the investment – i.e. providing a duty reduction of 4 percent of the value of qualifying investments in the year of the investment and each of the following four years. In the case of a qualifying investment of R100 million, for instance, the investor would be granted import duty credits totaling R20 million, of which R4 million could be used in the year of the investment and in each of the next four years. These duty reductions can be applied against duties otherwise payable on imports of OEM components or CBU vehicles.

In order to qualify for the PAA an investment must result in an increase in the scale of production of a particular product line and increased production for export. In other words, like the earlier export incentive program, this investment subsidy is also conditional on export performance.

In addition, the tariff provides considerable protection of production for sale in the domestic market. The level of such protection, of course, depends on the extent of import content. But illustrative calculations suggest that the effective rate of protection on production for domestic sales is at least 44 percent and could be over 100 percent (see Table 2 of Flatters 2002).

The paper focuses on exports as the major success indicator. In light of the size of the export subsidies it should not be altogether surprising that exports (and imports) of vehicles and components have grown under MIDP. However, in what sense can this growth of subsidized exports be considered an economic success? An illustrative calculation of the effects of the IRCC subsidy suggests that it creates a net economic loss of R20,000 for each R70,000 of South African resources used to produce a vehicle for export – the R70,000 of domestic resources brings in foreign exchange earnings worth only R50,000. Using data from the motor industry, it appears that each job maintained

in the motor industry through these subsidies costs South Africans at least R137,500.² Are these signs of a successful economic development policy?

In summary, a closer look at the incentives created by the MIDP and their implications for the behavior of domestic producers and exporters would cast considerable doubt on the value of using of exports, investment and production as indicators of success of the policies. Contrary to the paper's claim (p.21) that "the existing environment [for the automotive sector] is essentially tariff-free" the MIDP incentives depend critically on the substantial import duties on vehicles and components. And contrary to the claim (p.4) that after 1994 "export subsidies were removed" as an element of trade and industrial policy "since they were very costly...and were anyway becoming GATT-illegal," in the automotive sector a sector-specific export subsidy remains the central element of policy.³

International Competitiveness

MIDP proponents claim that as a result of the program South Africa has built or is in the process of achieving a world class and internationally competitive motor industry. The paper attempts to verify this claim by examining a number of competitiveness indicators in the components sector. No such data appear to be available for vehicles. It draws on data collected by members of the components producers association (NAACAM) on a variety of productivity and competitiveness indicators. (The paper points out, interestingly, that the activities of the "benchmarking clubs" that assembled these data are 65 percent funded by another DTI program that is seldom if ever mentioned as part of the MIDP. How many other subsidies are being given to the motor industry under separate DTI programs?)

The data show that there has been a significant improvement in these indicators between 1998 and 2001. The discussion pays less attention, however, to the levels of the indicators. A particularly interesting benchmark for this purpose is the set of indicators for components producers in other emerging economies (final column of Table 2 in the paper). A comparison of the levels achieved in South Africa in 2001 with those in other emerging economies shows South Africa to be lagging behind, and substantially so in many cases, in all but one or two of the 13 indicators.

The paper mentions in particular the problems with inventory control and points out the natural logistical difficulties of trying to operate a competitive industry using world class just-in-time techniques at the southern tip of Africa, far away from international markets for components and final products. This fundamental problem of geography would be very difficult to overcome except through permanent subsidies. It would be very difficult to construct an economic rationale for such subsidies. To the extent that inefficient port and customs services aggravate these difficulties, this would be an obvious target for "functional" policy reform measures. This is not explored in the paper.

² See Section 5.4 of Flatters 2002 for further explanation.

³ The WTO (in)compatibility of the current measures remains a real issue that is likely to arise in a number of contexts, including possibly the US-SACU FTA negotiations. While the WTO compliance issue is potentially serious, however, it is the domestic costs to South Africa that should be most important in guiding domestic policy discussions.

How can South African exports remain “competitive” despite these low productivity levels, even compared with other emerging economies? The obvious explanation, of course, is the export and subsidies provided under the MIDP and other programs. Economically insupportable export activities can be made privately profitable if sufficient subsidies are provided. The evidence presented in this part of the paper lends support to this hypothesis.

The Cost of MIDP to Consumers

As indicated earlier, economic analysis of the MIDP incentives suggests that a major part of the cost of the export subsidies and closely related tariff protection of the domestic market is borne by South African consumers. The basic theory of protection suggests that it will hurt consumers by reducing choice and raising prices relative to the opportunities that would be available in the absence of this protection.

A closely related corollary, of course, is that the substantial duty reductions on CBU motor vehicles over the 1990s and the early part of the 2000s should have resulted in lower domestic vehicle prices. But the import duties that remain in place under the MIDP will continue to ensure that domestic vehicle prices and consumer choice will be lower than they would be in their absence.

Although this is contrary to the paper’s main theme, it provides strong support for the contention that protection reduces consumer choice in South Africa. Under the umbrella of import protection, a small number of outdated budget motor vehicles is produced in South Africa, giving low-income domestic consumers a very limited range of choice. “Cars at the low end of the European market... are not imported into South Africa” and “the low-end of the South African market is served by cars that are outdated in Europe.” (p.14) “South African cars are both made to a lower specification and are dated in design and performance [compared with Europe].” (p.15) In particular, “The Fiat Uno and Toyota Tazz are face-lifted variants of successful late 1980s models, whilst the CitiGolf is an updated Golf 1, introduced in the late 1970s.” (p.14, footnote 12) As might be expected, none of them meet current European emissions-, economy-, and ride-standards. This is certainly contrary to the claim in the paper’s Summary that the evidence shows “how well-designed scale-enhancing selective policies can provide domestic consumers with global-quality products...without subsidy from the exchequer.”

In the absence of import competition at this end of the market, South African producers continue to “serve” the market with old technologies, higher petrol consumption, etc. This is a common result of protection aimed at developing “national” motor industries in low-income countries. The Proton Saga, Malaysia’s national car, for instance, is a Mitsubishi product that was phased out in Japan many years ago. This is a common and unsurprising result of protection in this sector.

What is much more surprising is the contention in the paper that the MIDP does not raise the cost of vehicles to South African consumers. This is surprising for two reasons.

- The *only* value of the MIDP IRCC incentives to vehicle and components producers derives from the ability it gives them to import vehicles and components free of duty and to sell the resulting vehicles at a higher price in the domestic market. If domestic prices are lower than those of imports, there is no benefit from obtaining the IRCCs and other credits and duty reduction privileges made available by MIDP. And yet the motor industry has recently

lobbied hard (and successfully) for an extension of MIDP. Why would they have expended the effort to do this if the import privileges are of no value?

- The contention that import duties lower the domestic price of import competing goods is astonishing in its own right.

The paper reaches its conclusion about the effect of MIDP on domestic prices by comparing retail vehicle prices in the UK and in South Africa. It does these comparisons for three groups of cars: budget cars, other cars produced in and exported from South Africa and other cars fully imported into and not produced in South Africa. As pointed out, the budget market cars in South Africa are not comparable to those sold in the UK. The other two groups comprise a sample of four models produced in South Africa (VW Golf 4, Toyota Corolla, M-Benz C-180, and BMW 318i), and a sample of two that are fully imported into South Africa (Renault Clio 1.2 16v and Alfa Romeo 147 1.6T).

For this sample of cars, the study reports that, after correcting for differences in sales and excise taxes, controlling at least partially for differences in product quality, and converting South African prices into £ sterling, South African prices are lower than in the UK.

Does this prove that the MIDP does not raise vehicle prices in South Africa? No.

First, the UK is a peculiar market with which to compare with South Africa. As is well known (and is pointed out in the paper), the UK automobile market has been notorious for its high prices. Using an indicator of the average premium of UK over other EU prices, the paper reveals that in three of the six cases considered, the conclusion about South African prices is reversed – i.e. South African prices are higher than in Europe. Looking further afield, comparisons of US and South African list prices for South African-made BMWs shows them to be 18 to 21 percent cheaper in the US.⁴

Second, as the paper observes, international price comparisons of complex consumer durables such as motor vehicles are fraught with difficulties. This is due in large part to the great degree of product variety and the impossibility of controlling for all product differences across international markets. Among the most obvious problems for the exercise in this paper, acknowledged by the authors, is that the budget market models sold in the South African market are simply unavailable in the UK and *vice versa*. How can sensible price comparisons be conducted in such circumstances?

Slightly more subtle but no less important are the large product differentiations witnessed even within the same model class. The paper tries to control for a few of the most obvious differences such as air conditioners, ABS brakes, air conditioning and sound systems. But it does not address differences in the qualities and specifications of these features in the different markets. More importantly, many other product differences are not controlled for at all – quality and materials used in upholstery and other interior trim, crash standards of bumpers, emissions controls, exterior paint variety and quality, other external trim features, length of warranty, conditions of after-sales service, credit arrangements, etc.

⁴ This US-South African price comparison was provided by Nnenzi Netshitomboni.

There is enormous product variety in the motor vehicle market. Vendors and producers engage in sophisticated product differentiation across markets, not just across international borders but often across regions in a single country. These differences are based on both marketing considerations and differences in regulatory requirements. The result is that legitimate international retail price comparisons are very difficult to make, and the results are therefore subject to great uncertainty.

Third, and most importantly from the standpoint of this paper is the fact that retail price comparisons simply do not address the question at hand. Recall that the question we are trying to answer is whether the MIDP causes consumer prices to be higher in South Africa than they would be in the absence of the program. Would vehicle prices be lower or higher than at present if vehicles could be freely imported at zero duty?

The retail price in any market is the sum of the cost of the vehicle itself and of all the costs of distributing and selling it. Distribution costs are a large share of the retail price of motor vehicles, and vary considerably across markets. This is due to differences in the industrial organization of the distribution sector and of the actual costs of distribution and sales. Distribution and sales, of course, are non-tradable activities and they are much more labor intensive than vehicle production.

As with most non-tradables of this sort, there will be systematic differences in their cost between high-income and low-income countries. In particular, we would expect that, other things equal, the retail price of vehicles in low-income countries would be a much smaller markup over factory or import cost than in high-income countries. Comparing retail prices, therefore, does not give an accurate picture of relative vehicle costs across markets. Comparing retail prices makes vehicle costs in low-income countries relative to those in high-income countries appear to be much lower than they really are.

The paper mentions a small part of this problem – differences in dealer margins. It claims that dealer margins are 6 to 10 percent in the UK and similar in South Africa. Whether or not this contention is true (and the paper acknowledges the very great difficulty of getting reliable data), the dealer margins are only a very small part of all the costs of distribution and sales, and there are many reasons to expect that most of these costs are lower in low-income countries than in high-income countries.

The only way to get around this difficulty, and to address the issue at hand, the effects of MIDP on consumer prices, is to compare factory prices in South Africa with c.i.f. import prices of similar vehicles. An international comparison of retail prices, even if it could be done properly, cannot answer this question.

Of course factory prices will be very difficult to get, for the same reason that it is difficult to get information on dealer margins. The necessary price comparison is almost certainly more difficult than the retail price comparison attempted in the paper. Does this mean we should be satisfied with the retail price exercise? No. Trying to answer the wrong question because it might be easier to do is not helpful. And in this case, as we have seen above, the “easier” question is almost impossible to answer satisfactorily anyway.

Does the paper provide any indirect evidence to support the surprising contention that costs in South Africa are equal to or lower than those of imports? No. As mentioned earlier, the competitiveness indicators presented in the paper suggest that South African producers are not internationally

competitive, even relative to producers in other emerging economies. And the great efforts of producers to secure an extension of the MIDP, whose privileges are of value to them only if domestic prices exceed those of duty free imports, suggests that import duties do have the expected result of raising domestic prices.

Overview of the Success of MIDP

Having concluded that the MIDP has been a success and that it has not imposed any costs on consumers, the paper provides a review of some of the reasons. Several points raised in this concluding overview merit brief attention.

Several explanations are given for the allegedly lower cost of South African vehicles, including high productivity growth, rising scale economies and low cost of imported inputs (p.19). As observed earlier, while productivity growth has been relatively rapid, productivity levels are actually still very low, even relative to emerging economies. Similarly, while the scale of production of certain model lines certainly has been increasing, the scales achieved so far are still very small by world standards. And, while duty free privileges on imported components lower costs, this simply begins to level the playing field of South African relative to world producers. It does not compensate for the natural logistical disadvantages of geography, and does not overcome the fact that vehicle pricing is determined by duties on vehicles and not components. In other words, none of these “explanations” gives a convincing reason to expect South African costs and prices to be lower than elsewhere. In fact they tend to give more support to the opposite conclusion.

It is also contended that the success “was achieved by an administrative regime which was not over-burdensome for users” (p.20). In fact, it is widely felt in the industry that the MIDP incentives are complex and burdensome. The system is criticized for its high compliance costs, the great discretion it grants to program administrators, and the difficulties it poses for firms in determining the tax implications of alternative business decisions. Multinational firms armed with sophisticated management systems and specialist auditing consultants claim to be unable to understand or contest administrative decisions on their accruals and uses of MIDP import duty reduction privileges. (See Flatters 2002.)

It is suggested that the early German export producers were drawn into South Africa by shortages in global production capacity and that this also had the effect of drawing in associated components investments (p.21). The contention that there are shortages in global capacity in the motor industry is questionable. Producers wanting to expand capacity have many alternatives. Both BMW and Toyota, for instance, have made major export-oriented investments in Thailand, much larger than in South Africa, for some of the same vehicles being exported from South Africa. Surely export subsidies are the best and most immediate explanation for their decision to divert a small part of this investment expansion to South Africa. Furthermore, as the paper observes, most of the growth in capacity in components has been in narrow product lines destined not for domestically produced vehicles, but rather for export. Once again, the MIDP export subsidies are the explanation.

In a very revealing discussion, the paper argues that the MIDP and other elements of the policy environment have forced assemblers and components producers to “confront the choice between integrating their South African plants into their global operations, or of forgoing significant access to this growing local and regional market” (p.23).

Another interpretation of the same facts, based on a closer understanding of how the MIDP actually works, is that international producers have not been forced to do anything. Rather, they have observed what is on offer in the MIDP trough and have simply come to have a good feed. The MIDP makes economically uncompetitive domestic and export production a source of considerable private profit. This certainly encourages investment, production and exports. But does it make good economic policy?

References

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