

The Economics of MIDP

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MIDP: The Context

- Importance of the motor industry performance
 - exports, investment, rationalization, competitiveness
 - size of the program (R55 billion in export subsidies from 1996 to 2003)
- A possible model for other sectors
- MIDP and industrial policy reviews now underway
- Misconceptions and disagreements about how MIDP works and its economic impacts

Outline

- Economic analysis of MIDP
 - How it works
 - Value of incentives/subsidies provided
 - Impacts and economic costs
- Processes for designing, managing and assessing MIDP
 - Capacity, independence, transparency and accountability
- General questions and implications

Background: Pre-MIDP

- Long history of industry protection
 - High tariffs led to a high cost domestic assembly industry; aggravated by local content rules
- Industry could not survive under deregulation and trade liberalization that started in the 1990s

MIDP

- Launched in 1995 to help the motor industry become competitive in the new policy environment
- Initially set for 5 years; extended twice; now scheduled to last until 2012 (17 years)
- Incentives were designed to rationalize production through specialization for export

What is MIDP?

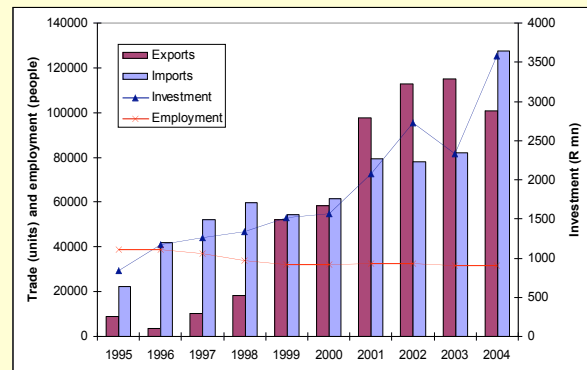
- High but declining tariffs on vehicles and components; virtual ban on used car imports
- No local content requirements
- Duty relief on imported inputs
- Duty credits for exports and for investment

(Note: Many other incentives; but this is the "core" of MIDP)

Industry Performance

- The industry has performed remarkably well since the start of MIDP
 - Vehicles: investment, exports and imports
 - Components: investment and exports (main products are leather seat covers and catalytic converters)

Vehicle Assembly



Size and Costs of MIDP Incentives

Key MIDP Incentives

- **IRCC:** import duty credits related to value-added in exports of vehicles and components; their value arises from importing duty-free and selling at duty-inclusive domestic price (benefit goes to exporters, not consumers)
- **PAA:** duty credit equal to 20% of qualifying investment, over 5 years
- **Duty Free Allowance:** reduces burden of duty on components; for domestic market; 27% of sales
- **Duty Drawback:** rebate of import duties on imported inputs for exports

Aggregate Costs

- R55 billion in export subsidies from 1996 to 2003
 - R15 billion per year in 2002 and 2003
 - in first 8 years R22 billion went to 2 German auto companies, and R37 billion to 4 companies
- This does not include subsidies due to higher prices of domestically produced vehicles sold in South Africa, or the costs of duty credits and rebates on inputs
- It does not include non-MIDP subsidies

Effects on Firms

- The economic effects of MIDP depend on the incentives they create for producers and investors
- Two kinds of estimates are reported here
 - Effective rates of protection provided to exports and to domestic sales of components and vehicles
 - Rates of subsidy to typical investments in the industry

Effective Rates of Protection

Effective Protection: Motor Vehicles (%)

	1995	2000	2005	2012
Export Sales	65	47	29	18
Domestic Sales				
30%	106	74	52	37
Import Share	125	87	61	44
50%	175	121	83	59
70%				

Effective Protection: OEM Components Exports (%)

	1995	2000	2005	2012
IRCCs used for CBUs:				
Converters	62	26	8	6
Other Components	62	33	18	11
IRCCs used for Parts:				
Converters	49	28	11	8
Other Components	49	35	23	14

Summary

- High but declining protection given to all activities
- Highest protection given to production for the domestic market (still as high as 83%, versus 29% for vehicle exports)
- In 2012 vehicle exports will still get 18% protection and production for the domestic market 37 to 59%; components exports will get the least protection

Net Subsidies to Investment

Net Subsidies to Investment

- Estimated as the increase in the net present value (NPV) of cash flows from typical investments as a result of MIDP incentives
- Increases in NPV are expressed as a percentage of the amount invested
- The investments are representative, but all parameters and assumptions can be varied in accordance with updated financial data

Results

- The investment subsidies are large; IRCCs are the main contributors to investment returns
- Although subsidy rates have been falling, they remain large

MIDP Subsidies: Typical Investments

Investment	Subsidy (% of amt. invested)
Auto Assembly, 1996	494%
Auto Assembly, 2005	275%
Components, 1996	681%
Components, 2005	264%

Some Economic Implications

Consumer Prices

- Domestic prices are higher than they would be in the absence of MIDP
- At the budget end of the market, the policies have also reduced the quality of cars available to domestic consumers

Rents and Economic Waste

- Subsidies to exports and production for the local market are either
 - necessary to cover excess costs of producing in South Africa (i.e. economic waste) or
 - unnecessary (because domestic production is competitive) and therefore create large rents for producers and investors
- Rents transferred to foreign shareholders are also economic waste for South Africa

Economic Waste in Non-Competitive Projects Due to MIDP

Investment	Economic Waste per Billion Rand Invested (R billions)
Auto Assembly, 1996	4.9
Auto Assembly, 2005	2.8
Components, 1996	6.8
Components, 2005	2.6

Employment

- Weak job growth in vehicle and components manufacturing
 - Jobs fell by 17% in the first 5 years of MIDP
 - In 2000-2004 employment in vehicle production hardly grew despite investment of over R12 billion; jobs in components grew by 1% per year
- Twice as many jobs in labor intensive sales and service; these have grown in step with vehicle sales; higher vehicle sales could provide many downstream jobs

Other Economic Issues

- External technology benefits
- Administrative and compliance costs
- WTO
- Competitiveness and sustainability without subsidies

Policy Processes

The MIDP Review: TORs

- TORs very broad and interpretation flexible
- The industry view is that the job is to extend MIDP and maintain current support levels in a WTO-consistent manner
- This assumes there is no need to review, from a national perspective, the overall economic costs and benefits of the program or of possible alternatives

Independence

- The motor industry appears to be playing a large role in the review
- This and previous reviews have been conducted by persons with close ties to the program and/or the industry
- The DTI's capacity in the sector appears to be weak and diminishing
- The apparent lack of independence highlights the fine line between cooperation and capture

Transparency

- Rules and regulations of the program are not easily available from government sources
- Data on program costs are not published anywhere
- Lack of transparency might help explain why the economic impacts are poorly understood and appreciated

The Way Forward

MIDP

- MIDP was meant to assist an inefficient industry become competitive and it has done so generously; the costs are high
- Adjustment assistance does not normally last forever; an independent assessment of MIDP's economic impacts is overdue
- Examine options for finalizing the motor industry's adjustment to a normal economic environment; consider the Australian model on which MIDP is based

General Questions

- What are the minimum requirements for economic analysis of benefits and costs of trade and industrial policies?
- Are industry subsidies such as MIDP the most effective way to create jobs and facilitate labor market adjustment?
- Do the capacity and process issues identified here provide lessons for the use of targeted industrial policies in South Africa?

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