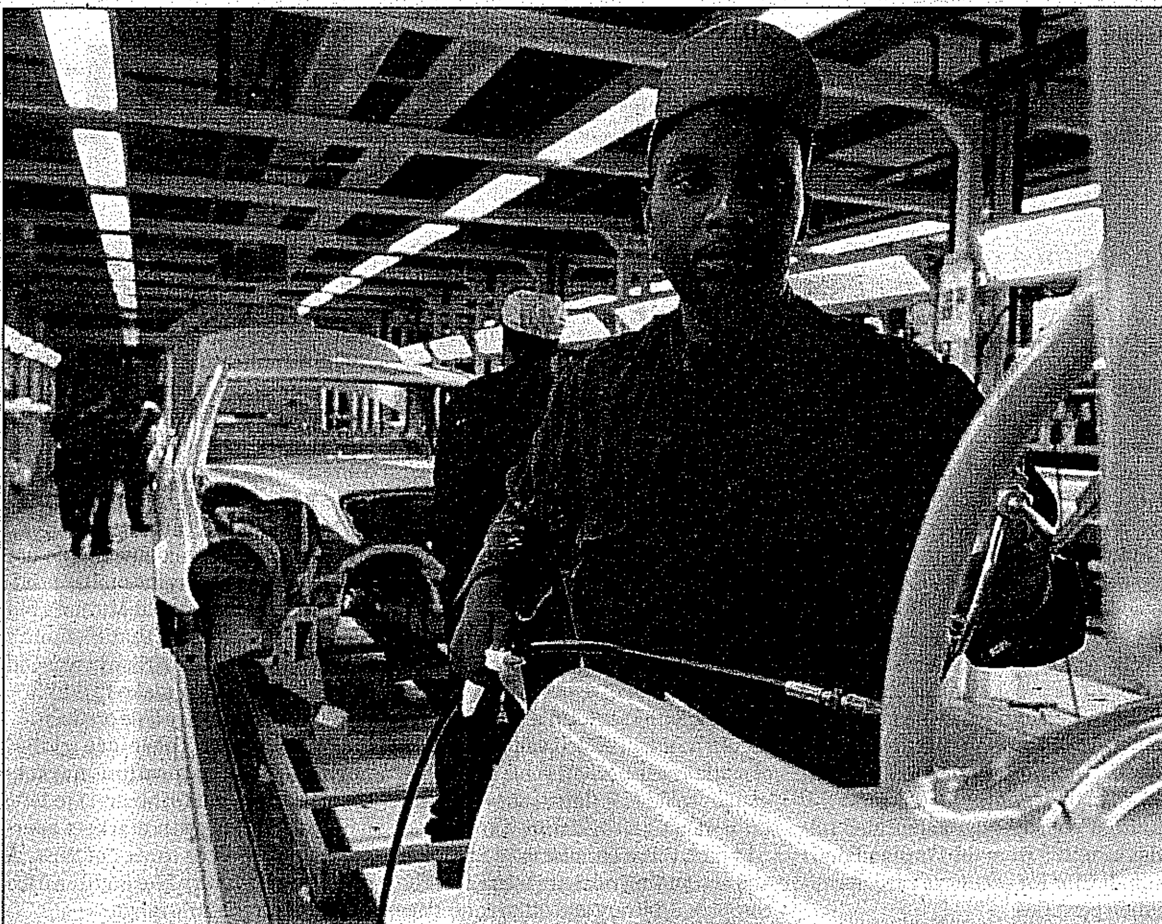
Frank Flatters on why South African car prices are so high

The R55bn under the motor industry's hood



Since 2000 employment in vehicle production has stabilised but not grown. Photograph: Paul Botes

The Motor Industry Development Programme (MIDP) is widely regarded as a major success of South Africa's post-apartheid trade and industrial policies. The programme was introduced in 1995, has been modified and/or extended several times, and is currently scheduled to continue until 2012. A Department of Trade and Industry-funded review, the third since the programme's inception, is now under way and is considering further adjustments to and possible extensions of the programme after 2012.

While most popular discussions focus on the MIDP's successes, questions have been raised about some of its unintended impacts. Following complaints about the failure of prices to respond as expected to the appreciation of the rand, the Competition Commission conducted an investigation into domestic motor vehicle pricing. The commission has pointed to the possible role of the MIDP in restricting consumer choice and maintaining prices at higher levels than in other markets. The motor industry, supported by a recent study by industry specialists, has disputed these claims.

The failure of policymakers to appreciate the costs of such an important programme raises serious questions about the government's capacity to design and manage sector-specific policies, and about the transparency and accountability of processes for monitoring and reviewing them.

The MIDP was initiated in 1995 to help the motor industry adjust to South Africa's reintegration into the global economy. Before that time, the industry was protected by tariffs of more than 100% and burdensome local content requirements. Unsurprisingly, it produced a very wide range of products at low scales of output and at high cost. It was a very inefficient import substitution sector that could not have competed either domestically or internationally in the face of immediate trade liberalisation.

The MIDP was designed to help the industry adjust and increase its competitiveness in the new post-apartheid trade policy environment. The programme had four principal elements:

- A gradual reduction in import duties on both vehicles and components;
- An export-import complementation scheme under which vehicle and components exporters can earn tradable "import rebate credit certificates" (IRCCs) to offset duties on imported vehicles and components;
- Access to the standard duty drawback programme for exporters, under which all import duties paid on components and intermediate inputs used in exported vehicles and components can be rebated; and
- A duty-free allowance on imported components of 27% of the value of vehicles produced for the domestic market.

The general patterns of motor industry performance since 1995 are quite well known. Vehicle exports grew from negligible amounts in 1995/96 to more than 100 000 units a year now. Imports grew from about 20 000 units a year in 1995 to 120 000 in 2004.

Investment in the vehicles sector has been substantial and has grown steadily, from less than R1-billion in 1995 to more than R3,5-billion in 2004, and has exceeded R2,5-billion in every year since 2001.

Components exports have grown in a similar fashion and are now more than R22-billion a year. While a wide variety of products are exported, more than 50% of the total is accounted for by just two — catalytic converters (38% of the total) and stitched leather seat covers (14%).

The MIDP creates substantial incentives to invest and to produce for export and for the domestic market. Producers for the domestic market benefit from tariff protection against imports and from the duty-free allowance, which offsets the cost-raising effect of import duties on components. Consumers pay for this through prices that are higher than they would be in the absence of the import duty on vehicles, and the Treasury pays by foregoing customs duties on components.

Firms producing vehicles or components for export qualify for duty drawbacks on all imported components and also receive IRCCs in proportion to their exports. These allow them to import motor vehicles (and components) duty-free and sell them domestically at the duty-inclusive price.

Evidence from the South African motor vehicle market confirms that consumers are paying at least a duty-inclusive price. Discussions of market pricing with South African vehicle sellers suggest that current prices are higher, not lower, than the duty-inclusive price. They say domestic prices can be thought of roughly as the sum of the cost of importing, all import duties and taxes, all domestic distribution and sales costs, including a normal return to all capital invested, plus another 10%, making South Africa one of the most profitable vehicle markets in the world.

The MIDP works by subsidising production of vehicles and components for both the domestic market and for export. The subsidies are paid for by domestic consumers of vehicles in the form of restricted choice and higher prices. The system of duty credits on exports means that consumers subsidise not only vehicles produced for the domestic market, but also those produced for export.

The import duties that the Treasury foregoes in honouring export IRCCs do not lower the prices paid by domestic consumers. Rather, they subsidise vehicle and components exporters while domestic buyers still pay (at least) a duty-inclusive price.

The MIDP subsidies are large. Between 1996 and 2003, automobile producers received and used IRCCs worth more than R55-billion. In 2002 and 2003 alone, their value was more than R15-billion a year. This is roughly equal to South Africa's total customs revenue collections and is 50% higher than the national government's total annual expenditures on higher education.

Over the first eight years of the programme, two German auto producers made use of more than R21-billion in IRCCs. These amounts do not include the subsidies received in the form of duty drawbacks, duty-free allowances or productive asset allowance. They do not include the implicit subsidy paid by consumers on purchases of domestically produced vehicles as a result of the protection provided by import duties and the effective ban on the import of used cars.

And they do not include any of the assistance provided by other government departments and agencies at the national, provincial and local levels.

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Gradually declining vehicle import tariffs have reduced the gap between South African and international prices. But import duties of more than 30% and a virtual ban on used-car imports still make car prices much higher than necessary. The constraints on consumer choice at the budget end of the market are illustrated as well by the continued profitable production of two obsolete models that have been discontinued in almost all of the rest of the world for decades.

Local production of a third such obsolete model was finally discontinued a couple of years ago, and continued duty reductions will eventually lead to the discontinuation of the others.

The effective rate of protection (ERP) is a measure of the amount of inefficiency that it is possible to maintain in domestic production and yet still remain competitive and profitable in South Africa.

Consider exports. An ERP for exports of more than 60% in the first few years of the programme means that domestic exporters could assemble vehicles at 60% higher cost than producers elsewhere and still be able to export profitably. The resulting export earnings might appear to be a saving of foreign exchange for South Africa. But each R100 000 of export earnings actually uses R160 000 of South African resources. Rather than saving foreign exchange, each R100 000 of exports is actually wasting R60 000 of domestic resources.

As the ERP for exports has gone down, the amount of such economic waste has diminished. But even at today's ERP of 29%, each R100 000 of export earnings could actually be costing R129 000 of South African resources and still be profitable for the exporter.

While the economic costs of MIDP might be high, maybe they have been necessary to generate badly needed employment growth. Has there been a payoff in terms of employment? For the first five years of the programme, employment in the manufacture of both vehicles and components declined by 17%.

Since 2000, employment in vehicle production has more or less stabilised, but has not grown. Investments of more than R12-billion since 2000 have resulted in virtually no job growth in vehicle assembly. Employment in components production (including tyres) has grown by a modest 6%, or just over 1% a year, over the same five-year period.

The industry has undergone a major structural readjustment, but the incentives provided throughout the life of the programme, and especially in the earlier years, were almost certainly much larger than has been recognised. As a result, the adjustment has not always been accompanied by corresponding increases in competitiveness, and voices in the industry are now calling for clarity on the government's intentions after 2012.

Without a continuation of incentives, according to some such voices, the industry, or at least some firms in it, will face serious financial difficulties. Potential new investors with time horizons beyond 2012 also wish for clarity on policies after that date.

It might be difficult and inappropriate to speed up the previously announced phase-down of tariffs up until 2012. It would certainly be worth emulating Australia by eliminating the duty-free allowance and IRCC incentives after 2012 and continuing to phase down of tariffs on vehicles and components to something like 10% and 5% respectively, in line with South Africa's general industrial tariffs at that time.

Given the long lead-time, there is no reason not to announce a very rapid, if not immediate, phase-down after 2012. Since the government's commitment to the productive asset allowance, even for the next few years, is much less clear, it might be possible to phase it out more quickly. The cases examined here suggest that this allowance is worth much less and hence causes much less damage than the export IRCCs, and so the gains from phasing it out might not be very great.

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This is an edited version of Flatters's presentation and discussion at the Trade and Industry Policy Strategies/National Economic Development and Labour Council South Africa Trade and Poverty Programme Policy Dialogue Workshop held in Johannesburg last week. The full report is available on www.frankflatters.com