



Protection of Thailand's Motor Vehicle Industry: Not a Blessing in Disguise

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The Ministers of Finance and Industry have announced the relaxation of import restrictions on new and used cars, and large reductions in import duties on motor vehicles and their components. Local auto producers object that this will lead to major dislocations in their industry. The Bank of Thailand raises the specter of a large increase in Thailand's balance of payments deficit. The Governor of Bangkok is alarmed that the resulting increase in the level and rate of growth in demand for automobiles will cause total gridlock of Bangkok's already congested streets. And others argue that the reduction in the taxation of this luxury good will sacrifice public revenues for the benefit of wealthy auto consumers.

If the critics of the new policies are right, the taxes and restrictions on motor vehicle imports have served a number of desirable policy purposes, and their abandonment will impose considerable social costs on Thailand. In other words, these restrictions and import taxes have been a multi-faceted blessing in disguise. To evaluate these alleged blessings, we look at: a) the effectiveness of the policy change in achieving its primary purpose, b) its possible effects on other social and economic goals, and c) the relative advantages of import restrictions and taxes compared with other possible policy instruments in achieving the primary and secondary goals of the new policies.

THE PRIMARY PURPOSE OF THE NEW MOTOR VEHICLE SECTORAL POLICIES

The primary purpose of the taxes and restrictions on motor vehicle imports has been to protect the local industry. The principal reason for reducing them is to reduce this protection. Protection of the local industry imposed a heavy tax on consumers and provided an enormous subsidy to those fortunate enough to obtain licenses and franchises to assemble vehicles locally. A 180 percent import duty on fully assembled (or completely built up—CBU) vehicles means that import competition only restrains local producers to sell at less than 280 percent of comparable import prices. A 300 percent duty makes local prices 400 percent of import prices.¹ Non-tariff import restrictions mean that even this minimal amount of competition might not be effective.

But, unlike most other taxes, the import taxes on automobiles do not automatically result in increased government revenues which might be used to meet important public needs. Since very few CBU vehicles are actually imported, the only government revenues that are collected are the much lower duties and taxes on CKD (completely knocked down) component kits and other parts imported by local assemblers. The major part of the tax on vehicle imports is passed on as a direct subsidy to domestic producers in the form of inflated domestic prices. This subsidy breeds some combination of inefficiency and monopoly profits to local producers.

The motor vehicle sector is one of the most heavily subsidized industries in Thailand. The subsidy arises from the much higher import duties on CBUs than on imported CKDs and other components. Assuming that, at world prices, the value of a typical CKD kit is 80 percent of the value of the final assembled product, the current (or old) import duties provide local assemblers with effective protection of 450 percent in the case of small cars (under 2300 cc. engine capacity) and 1,050 percent for larger cars. That is, Thai assemblers could have local costs which were 450 percent (or 1,050 percent) higher than those of producers in other countries and still be competitive against imports in the local market. Or, if they were as

efficient as typical foreign producers, they could price in a manner that would provide excess or monopoly profits that were 450 percent (or 1,050 percent) of local assembly costs and still compete with imports.

According to a TDRI study, the average effective rate of protection for all Thai manufacturing sectors was 29 percent in 1987 (45 percent if sectoral rates are weighted by import values).² Thus the subsidy to motor vehicles is at least 10 times higher than the average. By any standard, a reduction in the size of this subsidy would appear to be called for. The current proposal is that the duty on CBUs be reduced from 180 to 60 percent (from 300 to 100 percent in the case of large cars) and the duty on CKDs from 112 to 20 percent. Under the same assumptions as the previous calculation, this would leave the motor vehicle sector with effective protection of 220 percent for small cars and 420 percent for large ones, still many times higher than the average for all manufacturing.³ The implicit tax on vehicle consumers would remain very high, but much less than previously.

On industrial policy grounds, therefore, there can be no question that the tax and other changes are a move in the right direction. The only real question is whether they have gone far enough. We are aware of no economic argument that would justify subsidies to this sector which are so far out of line with other manufacturing activities. And the fact that Thai-produced motor vehicles are now being exported to North America suggests that there is no need for this sort of protection to ensure the sustainability of at least many important sectors of this industry. Further reductions in protection might see some healthy restructuring of the local industry, but they certainly would not result in its disappearance. Reductions in the protection-induced high costs of components and the basic materials used in their production would, in all likelihood, result in the much faster growth of a more export-oriented vehicle and parts production industry in Thailand.

SIDE-EFFECTS OF THE NEW POLICIES

While it may not be justified on industrial policy grounds, protection of the motor vehicle sector might still be called for on the basis of the fulfillment of other important social or economic goals. We will consider the principal ones that have been mentioned in recent discussions.

Congestion and Pollution

One of the principal effects of protection of the local industry has been to tax local consumers of motor vehicles. By raising their domestic price this policy has restrained demand. From elementary economics it is clear that reducing import taxes will increase demand and hence also congestion and pollution, especially in Bangkok. Countering the effects on pollution of increased numbers of automobiles, of course, will be the reduction in the average age and hence the increase in the average quality, including emissions characteristics, of the stock of automobiles being used.

But are these sorts of considerations really relevant? Thailand still has a relatively low number of automobiles and other motor vehicles per capita. Many other countries, with much higher levels of per capita motor vehicle ownership, have far lower levels of congestion and vehicle-related pollution than Thailand. It is apparent that Thailand's, and especially Bangkok's, pollution and congestion are not caused simply by too many vehicles.

Bangkok's congestion is due to inadequate and improperly managed transport infrastructure. Relative to population or land area, Bangkok has only half the amount of space devoted to roads as do comparable cities in the world. The roads that do exist suffer from an almost total absence of feeder or connector roads. The long waiting periods between light changes at major intersections are unique and demonstrably highly inefficient and alternative, public transportation is woefully underdeveloped and poorly organized. The resulting congestion is not only enormously costly in terms of wasted time and fuel, it is also a major cause of vehicle-related pollution. But even under much more ideal driving conditions, Thai vehicles emit far more airborne and noise pollution than is necessary. This is due to the absence of any standards or incentives to do otherwise.

These are the problems that must be tackled. In the short run, of course, it would be desirable to control the use of motor vehicles at peak times and in congested areas. Under current conditions, private vehicle users have no incentive to take account of the very high congestion costs they impose on others when using their vehicles. Even with a much more appropriate road system these costs, while much lower than at present, would continue to exist.

High import taxes, by reducing the number of vehicles per capita, undoubtedly have some beneficial impact but they are an extremely blunt instrument for this purpose. They tax vehicle *purchases*, not their *use* and they certainly do not discriminate between the use of vehicles in Bangkok and elsewhere, or between those used during rush hours and at other times. A major improvement over import restrictions would be excise taxes on motor vehicles that did not discriminate between those that were locally produced and those that were imported. These would be equally blunt with respect to their lack of relationship to the actual use of the vehicle. But they would have two major advantages over import taxes. First, since they would not discriminate between locally produced and imported vehicles, they would not have the costly side effect of subsidizing inefficient and/or monopolistic domestic producers whose products have no advantage over imports in terms of reduced congestion or pollution. Second, the excises would provide revenues to the government which could be earmarked for the provision of improved urban transport infrastructure.

Another suggestion has been to raise vehicle registration fees. If these fees were differentiated according to where the vehicles were used so that those in Bangkok, where congestion and pollution costs are highest, were greater than those charged elsewhere, this would be an improvement over other forms of sales taxes. But these fees would still have no effect in altering actual use patterns and deterring owners from using their vehicles when and/or where congestion costs were highest.

Furthermore, registration fees in Thailand represent only a quite small share of the cost of owning and operating a vehicle. The present value of the registration fees of typical motor vehicles are less than one and a half percent of the vehicle's purchase price. Thus, an extremely large increase in these fees would be necessary to compensate even for relatively small reductions in import taxes. Furthermore, at the moment, registration fees are not differentiated by the region of the country in which the vehicle is registered. Any attempt to implement regionally discriminatory registration fees would probably be frustrated by owners' registering their vehicles in low-fee regions. Bangkok region registrations currently far exceed the number of vehicles actually in use there. This is because finance companies register their legal ownership in proximity to their head offices in Bangkok, regardless of the location of the purchaser to whom they have provided the vehicle purchase loan. Any attempt to impose higher fees in Bangkok would result in a swift change in this practice, not only by finance companies, but by many other registered vehicle owners as well.

Taxes and other restrictions on vehicle purchases, production or ownership are extremely blunt and not very effective instruments for dealing with the problems of urban congestion and pollution. A significant part of both the short-run and the long-run solution to these problems must consist of measures which discourage vehicle use in areas where and at times when congestion costs are highest. Many such schemes are possible, with the most promising being a fee-for-permit system for driving in central areas of Bangkok during peak times. These and many other schemes for improving urban transport infrastructure have been known and discussed for many years. Maybe the concern that has arisen from the prospect of a vehicle demand spurt due to import tax reductions will be sufficient to provoke some long-needed action on this and other fronts.

Regardless of the short-run effects of motor vehicle tax changes, rising incomes are sure to cause rapidly growing demand for and use of motor vehicles. In the absence of improved policies, congestion and pollution can only get worse. It would be better for the underlying problems to be tackled sooner than later.

Balance of Payments

Another fear that has been mentioned is that the liberalization of vehicle imports will lead to a flood of new

imports and a serious increase in the balance of trade deficit. In other words, protection of the local vehicles sector has been a major instrument in preserving Thailand's fragile balance of payments.

The most important point here is that the balance of payments is not driven fundamentally by sectoral policies, and sectoral policies are an inappropriate instrument for dealing with balance-of-payments equilibria. The balance of payments and its composition are determined by trends in overall productivity, inflation, monetary conditions, savings behavior, budgetary policies, the terms of trade, etc. Changes in a particular sector are important only inasmuch as they affect such macroeconomic variables. To distort investment, consumption and production decisions in one sector to achieve some aggregate balance-of-payments goals is first of all very costly and, second, unlikely to be effective.

But what would be the impact effect on the balance of trade deficit of liberalization of the motor vehicle sector? Such a liberalization could be thought of as having two types of effects on imports. First, at any given level of demand it would raise the share of imports relative to locally produced vehicles in total demand. Second, by reducing local prices it would increase the total demand for vehicles, both imported and domestically assembled.

The high import content of local vehicle production means that the first effect, increasing the share of imports in total demand, would have a very small impact on the balance of trade. The c.i.f. price of CKD kits is only slightly lower than that of CBUs. The foreign exchange savings from marginal increments in local content by eliminating some items from the kits is also very low. In fact, for these very reasons there are instances in which decreasing the local content of domestic assembly operations in this sector has had the net effect of decreasing the balance of trade deficit in this sector. Furthermore, reducing protection of basic industrial raw materials used in parts production, which has also been announced as part of the package, might lead to a substantial and meaningful increase in local parts production which would also have a positive effect on the balance of trade.

The extent to which import liberalization leads to an overall increase in demand for vehicles and hence also in foreign exchange expenditures depends on both the elasticity of demand and the extent to which other measures such as new excise taxes and higher registration fees are used to counteract the effects of trade liberalization on domestic prices. As discussed, there might be some argument, especially in the short run, for such taxes in order to reduce urban congestion and pollution. There might also be some argument on the grounds of equity (see below).

Finally, one of the most important effects of import liberalization might be the development of a strong and competitive export sector for both vehicle parts and final products. This depends on the relaxation of import restrictions on basic industrial raw materials as well as on vehicle components. If this were to occur, it would almost certainly swamp any negative balance-of-payments effects arising from increased imports.

Equity

Motor vehicles, especially passenger cars, are consumed only by the very wealthiest members of the Thai community. Therefore restrictions on vehicle imports which raise the domestic prices of these products are seen as a form of luxury tax. As we have already seen, however, import restrictions have two effects—by raising local prices they tax consumers and also subsidize domestic producers. It is difficult to see how a policy which transfers income from a group of wealthy consumers to a number of inefficient and/or monopolistic producers can cause a significant improvement in overall social equity. It certainly has very little beneficial impact on the poor.

Much more effective would be an excise tax that did not discriminate between imported and domestically produced vehicles. Rather than subsidizing local producers, this tax would raise revenues that could, at least in principle, be used to provide measures that would benefit the poor. If the revenues were not used for this purpose, of course, the equity effects would once again be minor at best.

In the design of a set of excises on motor vehicles, it would also have to be recognized that vehicles are

used for many purposes that benefit the poor. Trucks and other vehicles are used to transport the produce of small farmers to market. They are used by poor commuters. And so on. Increases in the cost of these forms of transport would hurt the poor. Careful study would be required to ensure that any system of vehicle excises did not have serious harmful effects on the poor.

What is apparent in any case is that tax, trade and industrial policies in the motor vehicle sector, if not totally irrelevant, are certainly not ideal instruments for achieving the country's social equity goals.

CONCLUSION

Critics of the motor vehicle import liberalization have suggested that many different types of harm will arise from this decision. It will cause serious dislocation of the motor vehicle sector; it will lead to a major deterioration of the balance of payments; it will cause impossible aggravation of road congestion and pollution, especially in Bangkok; and it will result in further deterioration in the distribution of income. If all of these claims were true, then it might not be too great a leap to suggest that we had perhaps unwittingly discovered in import protection of the motor vehicle sector an elixir that was capable of solving all of the country's economic and social ills.

Unfortunately, a closer examination reveals that these claims are unfounded. Motor vehicle import protection is not and should not be used as a magic pill to solve problems of congestion, pollution, the balance of payments, and income distribution. In some cases this protection might have had minor beneficial side effects; in many others the side effects have been harmful. But in all instances it is clear that other instruments would be far more effective in dealing with these problems. Import protection is primarily a tool of industrial policy. On these grounds the policy changes are clearly an important step in the right direction.

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