WHY AFTA MUST TRANSLATE INTO LOWER PRICES

M I E R S C O P E
By Mohamed Ariff

The importance of AFTA (Asean Free Trade Area) can hardly be exaggerated. Its importance stems not only in the geopolitical sense, lest Asean as a regional grouping would become irrelevant, but also in economic terms, as it would render the region internationally competitive. It is indeed commendable that the Afta process has turned out to be much faster than initially planned. What is more, Afta has become the common denominator of a number of RTA (regional trade arrangement) initiatives, including China-Asean, Japan-Asean, US-Asean and India-Asean. All this underscores the need for Asean countries to first integrate their economies under the Afta umbrella before they can successfully integrate with others.

Free Trade Area (FTA) represents a loose form of regional integration, which allows member countries to keep their own tariff regimes against non-members, while eliminating all trade barriers among themselves, quite unlike Custom Union where members adopt common tariffs against the rest of the world. Such preferential regional arrangements are viewed as "second-best", the "first best" being the multilateral approach which is non-discriminatory. For some liberalisation of trade is considered better than the status quo. And, regionalism is also increasingly seen as a stepping stone towards multilateralism.

Understandably, trade liberalisation tends to punish inefficiency and reward competitiveness. Industries that were previously protected by tariff and non-tariff barriers would stand to lose out, as increased imports at lower prices would threaten their existence, while competitive industries would gain significantly through freer access to the markets of member countries. The substitution of high-cost domestic products with low-cost partner products is actually a positive thing, labeled as "trade creation", as it brings about a more efficient allocation of resources. If, however, imports from partner countries, due to preferential treatment, displaces cheaper imports from non-member countries, the effect, dubbed as "trade diversion", is negative, as it implies a shift from a more efficient source to a less efficient one.

Experience in North America, Western Europe and Latin America, has shown that the net effect is positive with trade creation outweighing trade diversion. Simulation exercises have shown that this will also be the case with Afta. Such analyses are admittedly static. The dynamic effects of FTAs, more often than not, are positive as well.

Above all, the consumers are the greatest beneficiaries of FTAs, as they can enjoy lower prices, except under very rare circumstances where the combined supply and domestic demand schedules intersect at a higher point than previously. To be sure, the latter is no more than a remote, albeit theoretically interesting, possibility. As prices fall and consumption increases, "consumer surplus" grows. Thus, the gain in consumer welfare is a major merit of trade liberalisation even in the "second-best" case, although it would pale somewhat in comparison with that under the "first-best" scenario.

Consumers in high-tariff countries will benefit most, as prices under FTAs would be significantly lower than previously. Conversely, FTAs would make little difference to consumers in low-tariff countries, as they have not suffered much from tariff-distorted prices in any case. Malaysia is a relatively low-tariff country, with trade-weighted average tariff rate being roughly 8 per cent. Seen in these terms, the gains that consumers in Malaysia can look forward to under Afta, generally speaking, will not be as large as that of their counterparts in Thailand or the Philippines.

One must, however, hasten to add that such averages do conceal a lot of variations. On some specific items, tariffs in Malaysia are much higher than elsewhere in the region. A notable case in point is the high protection accorded to the national car industry. Import duty on passenger cars in Malaysia depends on engine capacity: the applied tariff rates are 140-300 per cent for CBU (completely built-up) motor vehicles and 80 per cent for CKD (completely knocked-down) automobiles, 60-200 per cent for four-wheel drive CBU and 40 per cent for four-wheel drive CKD. Under Afta, these tariffs will eventually be reduced to no more than 5 per cent. The auto sector has been given a breather in implementing the Afta tariff schedule so that tariffs will be reduced, not in 2003 as originally planned, but in stages to 20 per cent in 2005 and 5 per cent in 2007.

With tariff rates so drastically reduced, automobiles should come substantially cheaper for the consumers depending on the depth of tariff cuts, *ceteris paribus*. But, other things may not remain unchanged. There are already policy indications that the government may impose domestic taxes to compensate for the loss of revenue arising from tariff cuts. Does this mean that the prices of cars will remain unchanged even under Afta?

Much depends on the tax rate, which in turn would depend on the tax objective. If the objective is to fill in the revenue loss, the excise duty need not be as high as the import duty. The logic is simple. High tariffs need not necessarily mean high tariff collections. Theoretically speaking, if the tariff rate is prohibitively high, no imports would take place and no revenue will therefore be collected. The purpose of the high tariff in this example is obviously to shut out imports completely, not to collect revenue.

In the Malaysian case, the tariff rates on automobiles are high but not prohibitive. In other words, high tariffs have discouraged, but not precluded, imports of motor vehicles. It is important to underline that the main purpose of high tariffs is not tariff revenue for the government but tariff protection for the national auto industry. Tariff revenues are simply secondary. The amount of tariff revenue collected would equal import value times the applied tariff rate. Import value would depend on the models and number of units imported. The fact remains that imports account for less than one-third of the total number of motor vehicles sold in the country, now that the national cars claim a market share of over two-thirds. As excise duty will be imposed on *all* cars, including the national cars, the tax rate need not be as high as the tariff rate, if the purpose is to only recover the revenue loss arising from tariff cuts. Such reasoning would lead us to the inescapable conclusion that cars should be cheaper under Afta, despite the imposition of excise duty to recover the revenue loss.

However, it is not inconceivable that the government may want to impose an excise duty that is high enough to prevent the car prices from falling. But, then the revenue collected will far exceed the tariff revenue the government would forgo under Afta. This is indeed an interesting possibility, especially if the objective of the excise duty is not revenue substitution, as suggested, but limiting the number of cars on the road through the price mechanism. It is not uncommon for governments to impose high domestic taxes on cars so as to discourage car ownership and sales for environmental reasons.

Should car prices fall markedly under Afta, notwithstanding the imposition of a revenue-substituting excise duty, the chances are that the car population would increase sharply, as demand is quite price-elastic. And, this may prompt the government to artificially raise the price of cars through additional taxes. But such a move will not be in the interest of the national auto industry. As domestic taxes will have to be applied on all automobiles without any discrimination, there will be no exemption for the national car makers. In other words, the national cars will not benefit from such taxes, which will only render them more expensive than they are now, unless of course costs are trimmed down substantially to competitive levels.

In any case, Afta represents a major watershed for the national auto industry, as it will no longer be able enjoy the favourable treatment at home. It has to cut costs substantially not only to minimise the erosion of the domestic market share under Afta, but also to penetrate into the markets of other Asean countries, taking advantage of the Afta access. Cost can be reduced significantly under Afta, as the national car makers will be able to source their components and parts from regional suppliers at low prices, but this will be at the expense of the current vendors. It is no secret that the 80-90 per cent high domestic content has been a drag on the competitiveness of the national cars.

The main threat to the national cars under Afta will come from Thailand, which is positioning itself as the Detroit of Southeast Asia. There are roughly 800 manufacturers of auto parts in Thailand, while the number of foreign affiliates or subsidiaries in the auto parts industry exceed 230. Many big names in the global automobile industry are setting up bases in Thailand in anticipation of the Afta market opening. To qualify, all they have to do is to ensure that their motor vehicles have a 40 per cent regional content.

Expectations about Afta are high both within and without. It will be an anticlimax if it fails to translate into lower prices for products traded intra-regionally. The main selling point about Afta is that it would allow what economists call "rent", which protection awards to producers producing for a captive domestic market, in the guise of monopoly profits, to be converted into lower prices for the consumers.

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