Several governments in Europe have introduced special consumer subsidies to help their motor industries. In 2009 the UK government launched a vehicle scrappage scheme co-funded with the car industry that had the objective of increasing the demand for cars in the UK. Broadly, it enabled consumers to scrap vehicles older than ten years provided that they had owned the car for at least 12 months to replace them with new vehicles at a discount of £2,000. The scheme was introduced in May 2009 and ended in March 2010.

Evaluate the economic arguments for and against the government providing a consumer subsidy to the UK car industry.

Vehicle industry feels the force of the recession
The global recession as a whole greatly affected the automotive industry, as aggregate demand (as well as short run aggregate supply) was hit, consumer expenditure declined due to a huge decrease in consumer confidence as well as a severe reduction of credit supply and an increase in the saving ratio. Since loans from the main commercial banks are the biggest source of consumers’ funding for purchases, many people found it hard to take out the necessary loans to purchase a new car - sales slumped and so too did output in the industry.

In 2009, for example, sales of new electric cars in the UK hit rock bottom. Sales in the ‘green’ automobile industry plummeted by 90% from 2007 levels. This can be traced back to the recession and high premium prices of new vehicles and the soaring price of fuel at the pumps.
Due to this steep fall in demand, the Labour government introduced a £5,000 incentive for consumers to buy new low-carbon cars - but there was a major flaw with this plan: This discount was only eligible for 2 cars: The Tesla Roadster, which usually cost £87,000 and the Mitsubishi i-Miev which cost £25,000. This meant that in order to receive such a discount, consumers still had to pay at least £20,000 which was far more money than people would normally spend on a new car, especially with the fear of a double-dip recession circulating.

When the vehicle scrappage scheme was introduced into the UK auto market in May 2009, it was perhaps not taken into account that most consumers would most probably not be strongly attracted to the idea, with such a limit on their choice of car, as well as potential cost exchange. One of the aims of a subsidy is to boost demand, and this scrappage incentive was meant to act as a stimulus for consumers. Ultimately, the plan was to reduce the number of cars over 10 years old that were running inefficiently - the subsidy would offer the consumer a £2000 discount in the purchase of a more economical vehicle. Furthermore, when the scrappage scheme was introduced, many environmentalists excoriated the government for not providing a better deal on ‘greener’ cars to the public.

**Global Car Scrappage Schemes:**

**United States**

In the USA, their system was known as ‘Cash for Clunkers’, whereby the government provide a $3,500 to $4,500 subsidy in return for old ‘bangers’. Officially known as the Car Allowance Rebate System (CARS), it was designed to provide stimulus to the suffering US automotive industry while getting cars with fuel efficiency lower than 18 miles per gallon off the roads. An example of how popular this CARS scheme was is that the Department of Transportation reported in August 2009 that the program had resulted in 690,114 dealer transactions submitted, in total requesting a total of $2.877 billion in rebates. By the end of the program, Toyota had seen sales growth of 19.4%, General Motors 17.6% and Ford 14.4%. However, although these automotive corporations experienced a huge growth in sales, this did not translate directly into profits. The way the program was set up meant that the dealers themselves provided the discount of $3500-$4500 directly to the buyer and were then reimbursed by the government, or at least they should have been.

The problem was that the scheme was begun before the government had secured enough funding to support overwhelmingly high demand for it. When the administration realized this, rather than stopping the scheme and starting it back up, which could have weakened consumer and business confidence even more, it carried on with promises to reimburse firms later. This delay in, and in some cases, absence of reimbursement resulted in cash flow problems for a number of dealerships and many actually pulled out of the program entirely. Although the CARS scheme was a good idea in that it was designed to help ‘bail out’ the automotive industry by boosting demand for their cars and to reduce America’s yet-like carbon footprint, it fell through because the government didn’t anticipate it to be so effective.
Russia
Russia have also introduced a car scrappage scheme this year, Industry Minister Viktor Khristenko announced that the government planned to buy 10 billion roubles ($340 million) would be allocated to buy a maximum of 200,000 old cars. Therefore the subsidy would be worth 50,000 roubles per car ($1,700). This applies to both Russian made cars and imports. The economic downturn lead to an unprecedented crisis within the Russian car industry, with Avtozav, the country’s largest car producer being hit the worst.

Germany
The German scrappage scheme has been the largest so far, with subsidies of €2,500 for cars older than 9 years, with a budget of €1.5bn. As a result of this scheme the car market soared with an increase of 40% (March 09 compared to March 08). However, German authorities discovered that people were taking advantage of this scheme and were illegally exporting an estimated 50,000 scrapped vehicles to Africa and Eastern Europe. The reason for this was because, contrary to the US ‘Cash for Clunkers’ program, the Germans did not require the engines of the old cars to be destroyed. They only had to be sent to a junkyard, thus allowing the illegal exports to take place.

Other countries that have implemented scrappage schemes incude: Austria, Canada, China, France, Italy, Ireland, Japan, Luxembourg, the Netherlands, Norway, Portugal, Romania, Slovakia and Spain. This is evidence that suggests that providing subsidies to potential car buyers is not limited to the UK. In fact it is a global initiative that is helping to stimulate growth in the auto-industry market.

Summary table (source: Wikipedia)

<table>
<thead>
<tr>
<th>Country</th>
<th>Maximum incentive</th>
<th>Age requirement</th>
<th>Emissions requirement</th>
<th>Cost to government</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>$4500 (~£3167)</td>
<td>Under 25 years old</td>
<td>No(1)</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Germany</td>
<td>€2500 (~£3552)</td>
<td>Over 9 years old</td>
<td>No</td>
<td>$7.1 billion</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>£2000 (~£3336)</td>
<td>Over 10 years old</td>
<td>No</td>
<td>$500 million(2)</td>
</tr>
<tr>
<td>France</td>
<td>€1000 (~£1421)</td>
<td>Over 10 years old</td>
<td>Yes(3)</td>
<td>$554 million</td>
</tr>
<tr>
<td>Italy</td>
<td>€3500 (~£7104)</td>
<td>Over 10 years old</td>
<td>Yes(3)</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: The Economist.[33] Notes: (1) The U.S. program does not have an emission requirement but instead set a fuel efficiency requirement. (2) The U.K. incentive is split between government and the dealer. (3) Italy and France required that new cars do not emit more than 160 grams of carbon dioxide per km.

Arguments in favour of a car subsidy

(1) Boost to consumer demand: Used cars create unnecessary costs to owners, as one could imagine the plethora of maintenance costs as well as poor fuel-efficiency which would have
to be paid for in numerous trips to the petrol station. Given the reduction in fuel-efficiency and the need for regular maintenance, owners experience higher costs and so a subsidy increases the incentive to purchase a new car. Similarly, those who have neglected their inefficient, older cars and instead, tended towards public transport may be attracted to the prospect of the price reduction of a new car resulting from the subsidy.

(2) Higher demand stimulating an expansion of supply: The rise in the demand for cars will in turn cause an increase in market supply. Therefore as the economy is running a large negative output gap and there is spare capacity the auto industry would need to invest in more machines and hire more workers. This means that more workers will find themselves with jobs, business investment would rise and therefore aggregate demand and supply should rise. A rise in aggregate demand and real national output will be beneficial to the market and the UK economy as a whole and thus lead to economic growth as real GDP increases. There are positive multiplier effects from an increase in demand, incomes and profits in the motor industry.

(3) Jobs: Since the car scrappage scheme was introduced into the UK, it appears there has been a protection of about 4,000 jobs in the UK automobile industry. This seems to have achieved one primary aim of a subsidy to a particular industry in that trade protectionism resulted from it - despite the fact that most cars are imported, many British engineering companies actually supply the parts overseas which are then incorporated into the cars that consumers import - which thus saved jobs in the economy.

(4) Some environmental benefits: The government would have environmental incentives for a car scrappage subsidy. The older the cars, the less fuel-efficient they are, and the government would want to stimulate demand for newer cars as they will contain newer technology. For example, the Toyota Prius, the first major hybrid electric car, only became available worldwide in 2001; all cars purchased before then will be either petrol or diesel fuelled. Professor Glaister from the UK RAC Foundation, said last year that "the vast majority of cars are still on the road at 10 years old. Indeed at 14 years old, half are still on the road." The government would want to stimulate demand for newer cars so that the new technology can be utilised more widely, and greenhouse gas emissions can be reduced.

(5) Effect on the market for used cars: A car scrappage subsidy reduces the risk of a rapid decrease in the market price for used cars, as people opt to scrap or recycle their old car instead of sell it on as many old cars will not fetch a price of more than the £2,000 subsidy offered by the government, and it is also just easier to scrap your car and receive the subsidy rather than go through the hassle of finding a dealer and negotiating a price. However, the stability that is created by the reduction in market supply can be countered out by the reduction in demand that will come from the subsidy; consumers will choose new cars over old ones as their purchasing power for new cars is increased by the subsidy, whereas they receive no such advantages from purchasing a second hand car (the £2,000 bonus is only offered to buyers of new cars).

Consumer confidence has improved but the motor industry is still facing difficulties in the poor economic climate.
The case against offering a subsidy to the car industry

(1) Demand for imported cars:
The subsidies that were given by the government to increase demand for new automobiles in the motor industry, an industry greatly affected by the world economic crisis (particularly in the United States), had a positive result that in February 2010, towards the end of the car scrappage scheme, 26% more cars were sold as compared to the previous year.

However, with the purchase of more cars came more caveats, as the instigation of the scheme angered some environmental groups, as well as the domestic car industry. The government’s pre-condition for the increase of demand was for the consumers to purchase new cars from domestic producers; however, the fact that most cars in Britain are imported (around 90%) negates the increase in demand created by the subsidy (as well as the macroeconomic increase in consumption and consequently aggregate demand). Therefore, the trade-protectionism aims of the government’s subsidy would have also been ‘scrapped’ as consumers purchase more imported cars.

Effect on the used car market

The scrappage scheme presents second-hand owners with a problem. Now that the public’s incentive to purchase new cars has increased due to the subsidy, second-hand car dealers
will have to lower prices to increase their competitiveness. Consequently, their profits will be affected and they will suffer extensively. This will have a negative effect on the economy as the government will be collecting less money from Corporation Tax to finance its expenditure and the second-hand owners’ own disposable income will decrease following the fall in prices. This will have a multiplier effect down the line as their consumption falls meaning that someone else’s income will decrease as a consequence of that.

**Limits to the green benefits?**

The environmental benefits of the scheme may not actually be as apparent as initially thought. The production of new cars emits further CO2; it would take longer than four to six years to offset the CO2 emitted while producing a new car. In order to qualify for the scheme, it is not necessary to buy a particularly environmentally friendly car. The purchased car will not necessarily be that much more fuel-efficient than the scrapped car, thus there is no justification for purchasing a new car. Smaller, cheaper cars often have less efficient engines than the more expensive rivals. Furthermore, if there is a subsidy introduced for new cars consumers will buy new cars more often instead of squeezing the last few years out of their old cars. Environmentally, this increase in the amount of cars overall will lead to a depletion in the supply of raw materials used in cars.

**Market distortions?**

For luxury car makers including Mercedes and Audi, the scheme may be rather irrelevant. A £2,000 reduction on an expensive car is minor. For example, an Audi TTS Roadster costs around £38,000 and a reduction of £2,000 is a decrease in price by a mere 5%. The incentive to buy the car will barely be affected as such a small proportion is likely to make very little difference. The BMW chief of production noted that their firm is “not particularly pleased by the scrapping scheme because it disadvantages premium brands like ours”. The scheme essentially distorts the market by hitting the top end of the market the hardest but benefiting the bottom end.

**Negative effects on public transport usage and revenues**

Not only does the scheme cost the government money in the subsidies themselves, but also in the loss or revenue that results. An increase in the demand and use of automotive transport will result in a decline in the revenue generated from public transport. With train tickets’ prices rising by three percent after George Osborne’s announcement, the incentive to use public transport is being decreased and will result in a loss of revenue. This in turn will reduce the amount of money the government can spend, capping any fiscal policy that the government had been looking to implement. The lack of this stimulus package can result in a drastic effect on the economy through the multiplier effect; the lack of expenditure will impact incomes. Therefore one can see that the plan could potentially backfire, costing the government millions and reducing AD through the multiplier effect.

**Not a long-term solution?**
The increase in demand for new cars, due to the scrappage scheme, will only be a short term spike in production. When the scheme ends there will be a fall in the production of cars, which will mean that the additional labour hired during the spike in demand will have to be fired or face wage cuts. However due to trade unions this will be unlikely to happen due to the sticky wages effect in which workers will refuse to accept pay cuts and also as unions will not accept loss of jobs. This will mean that car producers will have more people on their staff, possibly being paid more than before the scheme, but they will be making less profit as the amount of cars sold will fall to around the original level. This will cause the company profits to fall, and thus dis-incentivise them to supply cars.

It could also be argued that the increase in current consumption of cars will not change the long term demand for cars. It may merely encourage people to buy new cars now instead of a few years down the line. This means that later on the consumers who would be buying cars have already bought them under the scrappage scheme and so there will be a dearth of production then. It will also mean that the overall long term profits of car manufacturers will fall as they will most likely sell the same amount of cars over time but they will lose out on revenue during the period of the scrappage scheme as they provide a £1000 subsidy for each car, which will come out of their company profits.

**Car dealers raising prices using the subsidy**

It has been reported that the car scrappage scheme has been used by car dealers to drive up their prices. It would make economical sense for car retailers to compensate for the £1000 subsidy they too have to contribute by raising the price of their cars by £1000 or more. This has resulted in the ‘discounts’ offered for trading in older cars becoming irrelevant by the artificial price increases of many new vehicles. For example, US automaker Ford hit potential buyers of its popular Fiesta 1.25 60 studio with a ‘staggering hike’ of 32.6% to compensate for their loss through contributing to subsidies. They claimed that these price rises were essential to offset the effect of the weak pound which made foreign-made goods more expensive to import.

**Information failure - not the best deal around?**

If you are looking to replace an old car, the scrappage scheme might not be the most effective way for the consumers. [www.cardealmagazine.co.uk](http://www.cardealmagazine.co.uk) tells us that it was possible to get a nearly new Peugeot 207 for a total price of £9000 in the market in comparison to its listed price of £12,695. If customers were willing and dedicated enough to shop and search for a car in the second-hand market, they could find themselves a better deal.

**Has the car scrappage scheme been a success or failure?**

At the start of the financial crisis, it looked like car manufacturers were in trouble. When the government intervened and spent £400 million of tax payers’ money, there was hope that the motor economy would see a dramatic boost. Almost 400,000 new cars were sold because of this scheme, saving an industry on the verge of collapse.
Economically, the car scrappage scheme has been a blessing. The car scrappage scheme, which ended in March 2010, resulted in eight consecutive months of augmentations of car production and sales. A fifth of new car registrations were from the scrappage scheme, as reported from the Business Department. In the last quarter of 2009, it accounted for 0.1% of our GDP growth. Had this not been the case, the consequences would have been disastrous. As the car industry contracted, due to a lack of sales, thousands would have lost their jobs throughout the car making industry - from manufacturing to distribution to retail.

Many of the workers would still be in the welfare system, claiming benefits, as many in this industry have worked in it for years, some have become occupationally immobile. The scrappage scheme has prevented areas of the country concentrated on the car industry from descending into social deprivation as the increase in the number of long-term employed would cause great social problems.

Furthermore employment is a huge source of pride for many, and thus a high rate of unemployment would increase cases of anxiety and depression. Government intervention, with its support, would’ve restored pride and dignity to the industry.

We must also consider the environmental benefits. The government provided an incentive for road-users to take their inefficient, carbon dioxide emitting cars off the road. As a result, we now have newer cars on the road - that are more environmentally friendly.

We should also look at how related industries and markets have been affected. For example, substitutes to the car industry such as public transport and the car rental market. There is no doubt that fewer people would be using underground systems, train and buses; and the car rental market may have slightly lost out too, although this would have been a very marginal change, if anything.

The Society of Motor Manufacturers and Traders stated that ‘the scheme provided a vital stimulus to the automotive sector during a difficult economic period. While the 2010 market is expected to dip, the recent increase in fleet and business demand is expected to soften the impact to the end of the scrappage scheme’.

**Conclusion**
In conclusion the implementation of a subsidy scheme in the UK car market is a good idea during a recession, specifically when the car industry is already struggling; for example the Car Scrappage Scheme which ran from 2009-2010. However it must be run well to ensure that neither the environment is harmed nor the national trade balance. There would, also be no need for a subsidy in the industry if it is not already running with high spare capacity. Thus subsidies in the UK car market can be beneficial if it is well managed and implemented at the right in the economic cycle.

Articles used in researching this document - suggestions for wider reading
- www.guardian.co.uk/environment/2010/oct/21/electric-cars-uk-sales-figures
- www.guardian.co.uk/environment/2009/apr/16/green-cars-transport-incentives-emissions
- www.dailymail.co.uk/news/article-1322179/SPENDING-REVIEW-2010-Rail-fare-increases-transport-budget-slashed.html
- www.telegraph.co.uk/finance/newsbysector/transport/7539656/Car-scrappage-scheme-saved-4000-UK-jobs.html