[Received by email]

11th November 2003

Mr. Luke Van Hooft,
Productivity Commission
CANBERRA, ACT 2601

Dear Luke,

I refer to the recent request for submissions to the Productivity Commission's research project focusing on the appropriateness of the current CER Rules of Origin in determining preferential tariff treatment for goods traded across the Tasman.

As you are no doubt aware Country Road has been exporting to New Zealand since 1983 and, currently, operates wholly owned retail stores and franchises throughout the North and South Islands. It is obvious then that "Country Road" is vitally concerned with the issue of origin determination in the context of CER trade and therefore I wish to accept your invitation to submit a position paper on this subject.

Accordingly, the attached is Country Road's position with regard to the current CER "Rules of Origin" and encompasses the preferred options for change. Further, Country Road is of the strong belief that change is necessary not only to overcome the problems experienced in the past but also in order to position Australasia strategically given the important Asian/US trade negotiations taking place over the next few years.

I trust that you will give this submission due consideration and if there is anything further that Country Road can contribute to the debate please do not hesitate to contact me.

Yours sincerely,

Peter Deakin
General Manager, Supply Chain

A SUBMISSION

TO

THE PRODUCTIVITY COMMISSION

ON

CER "RULES OF ORIGIN"

PRESENTED BY

COUNTRY ROAD CLOTHING PTY LTD

11th November 2003

The CER "Rules of Origin"

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The CER "Rules of Origin"

1. Background

The Australia-New Zealand Closer Economic Relations Trade Agreement (CER) came into effect on 1 January 1983. It superseded the New Zealand-Australia Free Trade Agreement (NAFTA) of 1965. The key difference in the new agreement was that trade in all goods across the Tasman Sea was to be free of restrictions unless specifically set aside for later consideration. The objectives of NAFTA were less ambitious in that trade was only to be progressively liberalized in specified goods.

The aim of CER was to establish a trans-Tasman free trade zone by eliminating tariff, quantity and other restrictions on trade between the two countries - this has now been achieved. More recently, the Agreement has been extended to free up trade in services and to consider ways of harmonizing business laws and regulations to minimize hindrances to trade and commerce.

There was early concern in both countries about the structural change adjustment costs of the freeing-up of trade. In addition, to the slow phasing in of tariff cuts and the lifting of licensing and quota requirements, the CER Agreement detailed a series of “modified arrangements” for sensitive industries - one of which was the TCF industry. The liberalisation timetables for these sectors - which included industries subject to industry plans or to specific support measures - were to be stretched out in order to allow them time to adjust.

The general view was that most of the re-structuring in New Zealand due to CER occurred in the first two years of the Agreement while the impact in Australia would be more evenly spread over time and industries. Having absorbed most of the shock, New Zealand has been keen to extend the scope of CER and to review some of the other obstacles to optimal resource allocation. In particular, aspects of Australia’s industry policy - including bounties, Government purchasing arrangements and industry plans - have caused concern. It has been argued by New Zealand that free trade does not necessarily mean “Fair trade”. For its part the Australian Government has argued that the wider objective of its industry policy will not be sacrificed for a preferential trading agreement.

Nevertheless, the 1988 review of the CER Agreement took some major steps towards creating a single, undifferentiated trans-Tasman market. It was agreed that the trading agreement should be accelerated, widened and deepened. First, the date for free trade was brought forward five years to 1 July 1990. Second, the treaty was widened to include free trade in services from 1 January 1989 except for a short list of exempted sectors. Third it was agreed to deepen CER through harmonization of a range of policies and practices in several important areas including business law, quarantine and customs procedures, anti-dumping measures and technical barriers to trade such as product standards law. Some of these laws and practices involve the various Australian state governments and have proven to be difficult to achieve and protracted in their negotiation.

A further review of CER was undertaken in 1992 with particular emphasis on the application and effectiveness of the Rules of Origin. Unfortunately, and basically due to the stubbornness of Australian industry, only lip service was paid to the fundamental need for a review of the way in which origin is determined. Notwithstanding the foregoing, it should be said that the CER Agreement has gone a long way towards creating a one-market philosophy for both Australians and New Zealanders, but in order to maintain this exclusive preferential trading environment it needs to go further than it does at present.

The economic benefits of CER derive principally from rationalization within industries and specialization between industries. In other words, there are benefits to be had from both intra-industry and inter-industry trade. The gains from intra-industry trade are due to economies of scale and diseconomies of scope (i.e. reduced unit costs from specializing in fewer product varieties). The gains from inter-industry trade are due to more efficient allocation of resources.

Per capita, New Zealanders benefit from CER by around eight times more than Australians. This is a very large difference and is in part accounted for by the fact that Australia is a much more important trading partner for New Zealand than New Zealand is for Australia. The gains to New Zealand are mainly in the form of trade creation effects and arise from the ability of New Zealand to source a range of goods more cheaply from Australia than it could produce at home prior to CER.

Obviously then, the benefits for Australian manufacturing industries are in the areas of structural change and increased trade.

Increased trade, structural adjustment, rationalization and trans-Tasman investment have all contributed to the formation of a unified trans-Tasman market. This has occurred at the level of corporate-structures, at the level of pricing and marketing practices and at the level of component sourcing and the location of production facilities. CER has made significant progress towards the removal of some major obstacles to the unification of the markets. However, significant barriers to complete unification remain. Some of these are natural obstacles (for example; the distance between our two

countries) while others depend fundamentally on changes in thinking of the business community.

Notwithstanding the previous comment, CER has been associated with a shift in the thinking of the business people in New Zealand and Australia towards a more global perspective. Other forms of protection now need to be carefully justified. By forcing openness on some industries, the agreement has helped prepare the way for further unilateral, bi-lateral and multi-lateral trade liberalisation.

2. The Current Rules.

Origin is simply a statement of fact. However, preference is accorded to certain origins as long as specific criteria are met. CER is no exception and complex legislation (both here in New Zealand and in Australia) applies to the qualification process.

Simply put, goods of either New Zealand or Australian origin qualify for duty free treatment if they comply with one of the following provisions:

(A) Goods that are either wholly produced or wholly manufactured in New Zealand. As to manufactured goods, such goods must have been either wholly produced or wholly manufactured in New Zealand from materials in one or more of the following classes:

(i) Un-manufactured raw products;

(ii) materials wholly manufactured in New Zealand or in Australia, or in New Zealand and in Australia; and

(iii) imported materials that the Minister has, in relation to New Zealand, determined, by notice published in the Gazette, to be manufactured raw materials.

(B) Goods that are partly manufactured in either New Zealand or Australia, providing that:

(i) not less than one-half of the factory or works cost of each and every such article, in its finished state, is represented:

(a) by labour, material or overheads of that country; or

(b) by labour, material or overheads of New Zealand and Australia.

AND

(ii) the final process of manufacture of each and every article has been performed in that country.

There are complex rules applying to the treatment of various costs for the purposes of calculating area content. This complexity is compounded by different interpretations of eligibility for various components on both sides of the Tasman.

3. The Need for Change.

Bitter, protracted and intensive trans-Tasman Customs investigations have been the flavour of trade activity over the past few years. Additionally, there have been instances of varying treatment of certain components of 'cost' by the two regulatory authorities, i.e. NZ Customs and Australian Customs. This situation has been exacerbated by the devolution of vertically integrated clothing companies into design-houses and sub-contractors.

It is also incongruous that both the Australian and New Zealand governments have industry policies that actively encourage manufacturers in both countries to improve their efficiencies through the adoption of "best practice" principles. Only in this way, they say, will our industries be able to compete on a world scale. Unfortunately, this only magnifies the "content" problem, in that, as your efficiency increases your eligible "content" component decreases. This is the major weakness of the area content test and can result in identical goods manufactured and exported by different companies being the subject of different tariff treatments.

Furthermore, the current rules do not provide any certainty for companies making strategic decisions about market penetration of either market. Fluctuations in exchange rates, freight rates and world commodity prices can all adversely impact on specific inputs of apparel production.

Moreover, both trans-Tasman governments need to recognize that the adoption of the 50% rule was done in a totally different manufacturing context than that existing today and appropriately needs to be reviewed in light of current component global sourcing attitudes, the need to out-source manufacturing labour, technological change and improved business practices.

Additionally, the expected phasing duty rates in both countries will put pressure on both strategic sourcing decisions and the competitive nature of the Australian and New Zealand product in either market. As protection falls the CER product will come under increasing competitive pressure from third country suppliers. If CER is to survive, then greater emphasis will need to be placed on the preferential margin that CER goods will have in the trans-Tasman market.

4. The Options for Change.

4.1. Lower the current 50% area content requirement.

There are compelling arguments why a reduction in the content percentage should be considered seriously (please see comments above). However, this approach only results in shifting the goal posts and does not address the fundamental flaws of the existing rules.

4.2. Change the basis for determining area content.

Change the basis for determining area content from the current ex factory cost to either selling price or FOB export price. Naturally, this would include profit margins and selling costs - both currently excluded from "content".

In effect, this achieves a similar result to lowering the 50% area content in that it waters down the area content requirements of the present Rules of Origin. However, it does present some administrative problems to both governments as the additional factors of selling costs and profit provide scope for manipulation of area content and provides substantial opportunity for "creative accounting".

4.3. Move to a different measurement of content.

Replace the present 50% "value added" criterion with a "last substantial transformation" requirement and remove the "last process of manufacture" proviso. The ultimate test of "substantial transformation" being a change of tariff heading.

This proposal is in line with the system proposed in the Uruguay Round of Trade Negotiations. Countries such as the USA, Canada etc. have used "substantial transformation" as the base determinant of origin for years and it was the basis of the USA - Canadian "Free Trade Agreement" and also underpins the current "North American Free Trade Agreement".

4.4. Extend the "Determined Manufactured Raw Materials" (DMRM's) provisions.

Currently, DMRM's are used to calculate "content" when certain manufactured raw materials cannot be sourced from within the preference area. This concept could be extended to include any manufactured raw material that can enter the commerce of both countries at a duty free or minimum (concessional) rate. Under this arrangement "DMRM's" would be defined as goods that enter both Australia and New Zealand duty free under their substantive duty rate or under a Tariff Concession, that is; a duty free rate presumes that there is no local manufacture to protect therefore there can be no construed disadvantage to either country if "DMRM's" are able to be used to calculate area content.

4.5. A Common External Tariff.

Rather than viewing CER as something that has largely run its course, some people are beginning to see it as a forerunner of a new era in the external economic relations of Australia and New Zealand. There have been calls for complete economic integration of New Zealand and Australia. This would begin with the formation of a customs union, that is, an agreement on a common set of tariffs on imports into Australia and New Zealand from third countries. The next stage would require the formation of a monetary union with a common currency and a shared reserve bank.

However, this concept is unlikely to eventuate in the near future due to sovereignty implications.

4.6. List of Manufacturing or processing operations.

This method is usually expressed by describing, for particular product areas or specific products, lists of manufacturing or processing operations which confer, or do not confer, upon the goods the origin of the country in which those operations were carried out. In practice, this rule is usually not used as the main rule of origin. It is generally used to supplement the main rule of origin, particularly where the change in tariff classification rule is the "corner-stone" of the rules of origin.

It is common for this rule to be used to express operations which do not confer origin, i.e. insufficient processing operations. These could include:

(a) Handling operations;

(b) Simple operations such as sorting, classifying, washing, painting, etc;

(c) Packing;

(d) Labelling;

(e) Simple assembly;

(f) Simple mixing of products;

(g) Slaughter of animals; and

(h) A combination of two or more of the operations specified in subparagraphs (a) to (f).

This rule can also be used where a change in tariff classification does not occur, but sufficient processing has been performed to constitute manufacture. This situation can occur where:

(1) Goods are imported in an unassembled or a disassembled form, and pursuant to the Interpretative Rule 2A (a rule to classify goods) of the Customs Tariff, the goods are classified in the same tariff reference as the goods themselves, e.g.

CKD motor vehicle parts imported for assembly;

CKD furniture;

CKD white goods etc.

(2) Parts of goods are imported and the Tariff Heading (or sub-heading) provides for both the goods themselves and their parts, e.g.

8715 Baby carriages and parts thereof.

However, a process-based rule is fraught with administrative difficulties given that new technologies and processes are constantly evolving requiring continual updating of the rule. This factor militates against the “process” rule as a workable alternative to a "Change of Tariff Heading" system.

In summary then, lists of processes or manufacturing operations which confer origin are generally only implemented as an addition to the "Change of Tariff Heading" rule.

5. Country Road’s Preferred Method of Measuring “Content”.

It is important to remember, when discussing proposals for a change to the current CER Rules of Origin, that whatever system of origin determination is adopted it must be acceptable not only to the Governments of both nations but also to the business communities of both countries. In this regard, history has shown a predilection on behalf of the bureaucrats to implement a system

that satisfies their own agendas with little or no regard for the administrative effects their decisions have on the planning and strategic ability of companies involved in trans-Tasman trade.

It is therefore pleasing to note that there now appears to be recognition by Governments on both sides of the Tasman of the shortcomings of “content” as a basis of determining origin. Unfortunately, this is only the first tentative step towards agreement on a more transparent, predictable and administratively expedient set of rules.

In establishing its position with regard to "Rules of Origin", "Country Road" was cognisant of the fact that the "Change of Tariff Heading" method is being widely used in the world today and it is at the heart of current studies by the Customs Co-operation Council.

Further, in examining the volume of material written on the subject of “Rules of Origin”, in particular Rules of Origin adopted by the world’s trading blocs, it is apparent that no one simple Rule will satisfy the multifarious range of products that embody parts, components or raw materials originating in a foreign (non-qualifying) country.

Accordingly, most (if not all) trading blocs have opted for a mix of rules that satisfy local or mutual concerns. However, it is abundantly clear that the one underlying principle upon which the majority of rules are based is the concept of “Change in Tariff Heading” (CTH). In North America’s FTA (Free Trade Agreement) “Change of Tariff Heading” is used as a base determinant of “substantial transformation”. The FTA adopted the "Change of Tariff Heading" method since it permits the precise and objective formulation of the conditions determining origin.

Whatever rule is adopted its primary purpose is to establish criteria a product must meet if it is to be considered of Australian or New Zealand origin and thus entitled to the trade preferences available under the CER Agreement. Rules of Origin, in general, have become increasingly important in world trade as nations look towards regional (rather than global) trade as an answer to continuing economic pressures. This has resulted in a proliferation of preferential trading communities throughout the world with a concomitant need for a set of rules that confer qualifying origin on goods traded within the bloc.

Further, the internationalisation of production has made it increasingly difficult to assign origin unambiguously and to administer important trade policy measures directed at the products of specific nations. Given the extensive and important volume of trade between Australia and New Zealand, as well as trade between other partners, selection of an appropriate rule of origin is of paramount importance.

5.1. The "CHANGE OF TARIFF HEADING" Option.

In any preferential trading agreement origin rules establish the general principle that goods wholly produced or obtained from within the preference area will qualify for area treatment. It is only when goods are produced from materials sourced from outside of the preference area that origin rules become more complex and prescriptive. In general, the "Change of Tariff Heading" rule would confer Australian or New Zealand origin on a product containing foreign sourced parts, components or raw materials when sufficient additional manufacturing occurs within Australia or New Zealand, respectively, to change the tariff heading under which the product is classified. The rule would specify which tariff heading changes are sufficient for origin to be conferred and which are not. The rule would also provide for situations where assembly of an article from foreign parts does not result in a change of tariff heading. In these cases origin may still be conferred if the assembly adds at least 50 percent to the total value of the final article.

Basing origin determinations on tariff classifications would be a change from the current rules applying under the CER Agreement. The current rules require that "the last process of manufacture" must be undertaken in the country claiming preference together with a "content" qualification requiring at least 50 percent of the Factory or Works cost of the product to be also undertaken within Australia and/or New Zealand. The current rule is neither predictable for exporters nor easy to administer for either exporters or Governments. It relies almost exclusively on actual costs of production to determine origin and such costs are not generally known until after the production cycle has occurred, consequently denying the exporter his ability to strategically position his product offshore. The benefit of the "Change of Tariff Heading" rule is its predictability in that decisions as to whether origin is conferred have already been made and written into the rule, so that its administration is far more mechanical than the current rule.

5.2. The "CHANGE OF TARIFF HEADING" Rule Explained.

The proposed rule of origin is still based on the concept that significant economic activity that leads to a substantial transformation of the product must occur to confer origin. However, it explicitly defines substantial transformation, on a product basis, as a change in tariff heading under the Harmonized System for tariff nomenclature. Thus, when an article undergoes sufficient processing to change its tariff heading in the importing country, it may automatically have origin conferred in that country. The exception would be where it has been predetermined in the Agreement that a particular "Change of Tariff Heading" does not involve a substantial transformation of the product. Therefore, changes to certain tariff headings and subheadings are identified under this rule as not conferring origin. the proposed rule would also provide, under certain circumstances, that articles assembled from

foreign parts may qualify for a change of origin even though there has not been a “Change of Tariff Heading”. In these cases, a value added test of 50 percent must be met to ensure the significance of domestic content.

The benefit of using a “Change of Tariff Heading” standard is that it can be applied more mechanically than the “content” rule. In most cases, a “Change of Tariff Heading” would automatically confer origin. Since this rule relies on established principles of tariff classification, which provide guidance on what comprises a new and different article through descriptions of product categories, it is expected to be easier for Government to administer and for industry to use in its production planning.

At the same time, one of the problems in using a “Change of Tariff Heading” rule is that the tariff nomenclature was not designed with origin rules in mind. Any assembly, whether economically significant or not, will generally produce a “Change of Tariff Heading” at some level of classification. Under the proposed rule, however, not all assembly would confer origin; an additional, significant step in the processing or manufacturing of a product must have taken place, rather than simple combining or packaging. This is why there will be a need for certain tariff headings and subheadings to be set aside wherein a “Change of Tariff Heading” would not confer origin because there has been no substantial transformation. This modification of the “Change of Tariff Heading” standard acknowledges the fact that the significance of the assembly performed is not uniformly demonstrated by changes in tariff heading. As a result, a “Change of Tariff Heading” at a particular classification level (e.g. a 4-digit heading or 6-digit subheading) in one product sector might not confer origin, while a change at that level would be sufficient for other product sectors.

For example, under the proposed new rule a 4-digit level change of tariff heading may be sufficient to confer origin, as with a change to heading 1806 (chocolate and other food preparations containing cocoa) from any other heading. However, within heading 1806, only a change of subheadings 1806.31 (filled chocolate in blocks, slabs or bars) or 1806.90 (other miscellaneous chocolate and food preparations not in blocks, slabs, or bars) would confer origin; changes to all other 6-digit subheadings would be set aside and would not confer origin.

In this regard, the proposed rule almost mirrors the North American FTA’s use of change of tariff heading but differs from the European Community’s use of its rule of origin. The EC rule provides that a change in heading at the 4-digit level automatically confers origin, but then provides lengthy lists of exceptions where additional requirements must be met before origin is conferred. There are also exceptions that permit products to obtain a change in origin without a change of heading at the 4-digit level. The proposed CER rule, however, defines the required level of change (e.g. 4-digit or 6 digit) depending on the product, and these definitions will be pre-determined and written into the rule of origin.

Under the proposed rule of origin for the CER Agreement, in certain instances where assembly of an article from foreign parts does not result in a "Change of Tariff Heading", a value added test of 50 percent will be triggered. This occurs when (a) the article was imported in unassembled or disassembled form (such as a kit or CKD motor vehicle) and classified under the tariff category for the assembled article or (b) the article is classified under tariff sub-headings which provide for both the article and its parts. Then, if the value of the materials obtained or produced in either Australia or New Zealand, plus the direct cost of the assembly operations, constitute at least 50 percent of the value of the article, substantial transformation is conferred.

In this context, Country Road suggests that the definition of value added should be the same as currently applying under the CER Agreement.

Implementation of a "Change of Tariff Heading" based rule of origin for CER will likely face some problems. The most obvious problem being its newness for both Customs officials and the business community. However, the "Change of Tariff Heading" rule of origin can be written so that industry can predict with certainty the preference nature of their trans-Tasman trade. For this reason alone the "Change of Tariff Heading" rule has considerable merit.

Despite the more mechanistic nature of the "Change of Tariff Heading" rule, Customs still has a relatively complicated task, potentially requiring two classification decisions when a product using components imported from outside the preference zone claims exemption from tariff under the CER Agreement. However, verifying classifications will be considerably easier than current practice.

Additionally, there will need to be mutual enforcement of the rule of origin by both sides. Thus if a New Zealand exporter gives false information to Australian Customs, New Zealand authorities would need to take action against the firm in New Zealand; conversely, Australian authorities would take action against Australian firms that falsely informed New Zealand Customs.

Implementing the proposed rule of origin in the context of CER may create short term uncertainties and initial confusion due to the unfamiliarity of Customs and industry with the rule. However, it will create an easier and more predictable process in the longer term. Therefore, the use of a "Change of Tariff Heading" based rule represents mid-ground between the current "content" rule (least predicable) and a "process" based rule (most predicable).

6. Summary

Country Road believes that the approach outlined above in Paragraph 5 articulates the most desired outcome of any review of the CER "Rules of Origin" . In light of the existing trade and operational environment confronting all industries in Australia and New Zealand it is imperative that a clear, transparent and equitable system of determining origin be adopted and Country Road is of the opinion that this can only be achieved by embracing the concept of "Change of Tariff Heading". An example of how the "Change of Tariff Heading" rule would apply to apparel is contained in Attachment 'A'.

If however, the Government is of the opinion that a dramatic change at this stage would be far too radical then Country Road would support a move to reduce the current content qualifier to a more realistic level - somewhere around the 35% mark. Alternatively there could also be merit in considering the part that "Determined Manufactured Raw Materials" could play in the overall "content" argument.

Attachment 'A'

Proposed "Change of Tariff Heading" Rule for Apparel

1. Apparel - Knitted or Crocheted (Chapter 61)

A change to any heading of Chapter 61 from any heading outside that chapter; provided, that goods are both cut (or knit to shape) and sewn or otherwise assembled in the territory of Australia or New Zealand.

2. Apparel - Not Knitted or Crocheted (Chapter 62)

A change to any heading of Chapter 62 from any heading outside that chapter; provided, that goods are both cut and sewn in the territory of Australia or New Zealand.