

SUBMISSION ON ANZCERTA RULES OF ORIGIN

DEPARTMENT OF INDUSTRY, TOURISM AND RESOURCES

OCTOBER 2003

1. INTRODUCTION

The Department of Industry, Tourism and Resources has joint responsibility for Australian Government policy regarding rules of origin (ROO) with the Department of Foreign Affairs and Trade. The Department will not be proposing any specific changes to the ROO applied in the Australia – New Zealand Closer Economic Relations Trade Agreement (CER). Rather, the purpose of this paper is to provide background on the Government's policy on ROO and outline a range of issues pertinent to the administration of the CER which have arisen in recent years.

Until very recently, the CER has been our only major regional trade agreement and its objectives have largely been well served by its ROO. However, the transformation of the trading environment, brought about by changes in manufacturing processes, falling tariff levels, the proliferation of bilateral and regional trade agreements and the globalisation of industry over the past twenty years have implications for the ROO today. In particular, new bilateral trade agreements currently being negotiated with the US and Thailand, and potentially with other trading partners, are likely to generate new ROO with which industry must come to terms. This has created a need (and an opportunity) to look at other common approaches to determining origin and their appropriateness for the bilateral partnership being proposed.

2. ISSUES ASSOCIATED WITH THE ANZCERTA RULES OF ORIGIN

The CER ROO has two main elements that have counterparts in many other ROOs:

- an area value content requirement expressed as a proportion (50 per cent) of factory cost; and
- a physical transformation requirement expressed in CER as performance of the last process of manufacture.

Each of these elements has attracted some criticism and alternatives have been proposed from time to time. Below we discuss some of the issues and the alternatives.

2.1 The 50% factory cost requirement

Purpose of the provision

In the CER ROO context, because the transformation requirement is expressed simply as performance of the last process of manufacture, there is a risk that some processes of manufacture, while involving the transformation of the inputs into a distinctly different product, might involve a very limited amount of value adding in the exporting party. In these circumstances, third parties might be unintended beneficiaries of the trade agreement.

Under the ANZCERTA agreement, the regional value content requirement 50% serves to ensure that preference accrues predominantly to value added in the parties — and to limit the competitive neutrality issues discussed later in this paper.

Issues with the 50% rule

Vulnerability to price fluctuations

A key criticism made of value added rules is that they are vulnerable to fluctuating prices. If the cost of imported materials increases because of a reduction in the value of the currency or other reasons, the percentage of local content will fall accordingly. Fluctuating prices can potentially affect the ability of a manufacturer to claim origin from one shipment to the next, despite the amount and type of domestic processing they undertake remaining the same. The ANZCERTA agreement allows for some fluctuation through temporary derogations from the 50% rule. Some alternative value-added rules suffer from the same effect. One that does not is the US 'build-up' method of calculation since its denominator is determined from local material costs and the numerator is the fob price of the output; neither of which would necessarily be prone to exchange rate fluctuations.

Calculation of local content

The method of calculating local content, and in particular the treatment of imported, non-originating materials, constitutes an important element in the application of value added ROO, as well as its potential effects. The CER uses the factory cost formula, so called because it is based on the cost of the good as it leaves the factory. The CER ROO prescribes certain costs (qualifying expenditure) for use in the calculation of the factory cost. Qualifying expenditure is a subset of the total factory cost and there may be some variation in the outcome according to the financial structure and/or the level of vertical integration of the enterprise.

Implementation of the CER ROO requires effective accounting and record keeping procedures and assumes standardised accounting practices to ensure different cost items are treated similarly in different countries. This has created some difficulties for developing countries such as the South Pacific Island countries under the South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) which uses the same approach. This issue was also raised in discussions over the suitability of the CER ROO for an FTA with Thailand. Thailand indicated that manufacturers, in particular small businesses, could not meet the record keeping requirements of the CER ROO.

Variation with level and type of integration.

The costs included in the local content calculation are tied to the concept of the 'factory' where the last process in the manufacture of goods is performed. The level and type of integration of a firm (whether it operates the factory or has another firm do so) can affect the local content percentage outcome as some costs may be included or excluded in the calculation.

If the factory buys in the materials needed to produce a good, then the area content calculation will take account of all the capital costs (including profit on equity) involved in local production of those bought-in components. However, if the manufacturer produces a large proportion of its materials in-house, then the profit

element in cost of capital will be disregarded — leading to a lower percentage outcome (if all else is equal).

On the other hand, if a producer has the last process of manufacture performed by a sub-contractor, the result might be biased upward or downward, depending on the implementing legislation and on how the inputs into that last process are calculated. At present, under Australian law, much of the imported content going into the final process is disregarded where the last process is outsourced. This is recognised as a possible defect in our law and action is in train to examine changes. By contrast, New Zealand ignores some of the local costs that would have been captured in the fully integrated operation, resulting in lower local content percentages. That feature of the New Zealand law has been the subject of discussions between the parties.

Treatment of overheads

Where production is expanded (say for export to other markets), it can mean that average per unit overhead costs will fall, reducing the final value of local content for the purpose of the ROO. As overheads can constitute a significant proportion of costs deemed ‘qualifying expenditure’, this phenomenon may have a significant impact on the calculation of local content. The expansion of production and lowering of overhead costs would generally be seen as an improvement in economic efficiency and yet it can have the perverse effect under the factory cost approach of disqualifying a product from preference in the partner’s market. The overall effect could be to discourage efficiency enhancing expansion.

Accumulation of local content

The CER ROO does not permit goods processed within the free trade area to gain credit for prior area value if they go offshore for partial processing before returning to Australia or New Zealand for the final stage of manufacture. Accumulation was previously allowed under the CER but disallowed by agreement between the parties following a dispute in 1990 concerning claims of origin made by New Zealand jewellery manufacturers. Under previous rules allowing accumulation, jewellery made from the high value raw materials (gold) but largely processed (into chain links) outside the free trade area was able to meet the 50 per cent local content threshold despite minimal domestic processing.

Accumulation is allowed under the Singapore Australia Free Trade Agreement (SAFTA) for some products in recognition of the reliance of Singapore’s manufacturing industry on offshore processing. Adapting the basic CER ROO in this manner required that the bias against vertical integration also be addressed. This was done by specifying that ‘qualifying expenditure’ be attributable to the ‘principal manufacturer’ rather than to the ‘factory’.

New Zealand has, in the past, raised the effect of the threshold on offshore processing decisions. However, to date, offshore processing has not become a significant issue largely because of our geographic isolation. The main exception is the textile, clothing and footwear industry (TCF) which has been attempting to make greater use of low labour costs in nearby Pacific Islands. This process has been facilitated by SPARTECA.

Application of a single local content threshold

The CER applies a single rule to all products and takes no account of production costs and patterns in different industries.

The effect of a 50 per cent local content threshold is particularly marked where materials (inputs) are not available in either country. The cost of these materials alone may preclude conferment of origin. Australia and New Zealand have been discussing approaches to allow for such inputs.

To date, Australia has not supported a reduction in the local content threshold. Australia has argued that the current threshold achieves an appropriate balance between the interests of exporters and those of import substitution manufacturers. Further, any new threshold would remain to some extent arbitrary and the problem of marginal producers whose local content falls just short of the required percentage would remain. There is also a pragmatic basis for setting the local content requirement at 50 per cent. This threshold is the same as the requirement in the *Trade Practices Act 1974*. It has also been consistently supported by major Australian industry associations including the *Australian Industry Group*, the *Australian Chamber of Commerce and Industry*, the *Council of Textile and Fashion Industries of Australia*, the *Federal Chamber of Automotive Industries* and PACIA.

Though Australia has to date opted for retention of a single threshold under ANZCERTA, the threshold under SAFTA was varied for a range of products. Also, under the Thai Australia FTA, the local content threshold will vary from a level equivalent to ANZCERTA 50% and will vary between products. If the negotiations for the Australia US FTA lead to acceptance of ROOs based on the previous US agreements, then again there is very likely to be a variation from equivalence with ANZCERTA and variation across products.

Competitive neutrality

In Australia and New Zealand, duty charged on inputs is reimbursed (via duty drawback or an equivalent) when the final product is exported. This is permitted under the CER and creates a trade distortion because domestic manufacturers are not similarly reimbursed for duty charged on their inputs. In effect, duty drawback enables importers from a CER partner trading into the other partner to receive net effective assistance relative to domestic producers. The problem is especially apparent in the Australian and New Zealand clothing sectors where there are substantial tariffs on both inputs and final products.

To ameliorate this problem, duty drawback can be disallowed as it has been, for example, under the NAFTA and the subsequent US Singapore and the US Chile agreements.¹ However, disallowing duty drawback is only a partial solution where one country has greater scope for sourcing its inputs duty free than its free trade agreement (FTA) partner. This can occur because a country is party to numerous other bilateral or regional trade agreements or because its tariff is simply lower on those materials than the tariff on materials imported into the other partner. In these circumstances, regional value criteria that set a significant minimum on the amount of area value added can serve to limit the trade distortion that occurs.

Alternatives to the ex factory cost basis

The denominator

¹ In a customs union like the EU where there is a common external tariff and no allowance for duty drawback in trade between partners, the problem does not exist.

Most alternative approaches to calculating a regional value content percentage use the free-on-board (FOB) price of the export as the denominator

The use of FOB price, provided it is formed at arms length, should provide a reasonable basis for calculating an area content percentage. The main drawbacks of this choice are that some prices are not formed at arms length and, in some cases, the price embodies a large component for intangibles like design or brand recognition that have not been created in the trade area. Depending on the calculation approach the inclusion of intangible components may lead to a high percentage of area content despite little value added from local labour or resident physical capital.² The factory cost approach is one method of addressing this concern as it is based predominantly on costs incurred directly in the manufacturing operation itself. In the case of the CER, as noted earlier, factory cost does not include all economic costs incurred in relation to the factory, in particular, profit.

The numerator

Generally, the numerator can be calculated using one of two options which in broad terms correspond to the 'build-down' and 'build-up' approaches embodied in recent US agreements with Singapore and Chile. In the North American Free Trade Agreement (NAFTA), the alternatives are a 'build-down' approach and (instead of the 'build-up' approach) a calculation similar to the CER ex-factory cost formula, which uses the net production cost as the denominator. This will not be considered in its own right further here.

The **build-down** approach uses, as numerator, the difference between FOB price and the imported materials to the production chain. This sort of approach has the advantage of simplicity inasmuch as the manufacturer need only identify the imported materials used directly in the product and the imported content of non-qualifying inputs. There is no need to enumerate costs incurred on internal processes and allocate them across products.

The **build-up** approach uses, as numerator, the sum of the values of qualifying inputs, either bought in or made in-house. This approach can be administratively simple for producers that buy in significant components that they know to have originating status. Such a manufacturer needs only to enumerate sufficient originating components to pass the threshold hurdle and then need go no further. This method, unlike the factory cost approach or the build-down method, does not necessarily require a full enumeration of purchased inputs and a full determination of their qualifying or non-qualifying status.

2.2 The transformation rule

Under the CER rules, physical transformation of imported materials to a product of distinctly different nature is defined through the requirement that the last process of manufacture take place in the territory of the exporting party. This approach is non-prescriptive and the notion of what constitutes 'manufacture' has developed over time through case law. By and large, this approach works well but a potential exporter might have to obtain an advance opinion if the precedents are not clear on whether its production process constitutes 'manufacture'.

² See the discussion of alternatives to the ex factory cost basis below.

The main alternative internationally is the change of tariff classification (CTC) method. It is favoured by the US and the European Union and applied in the majority of their bilateral and regional agreements. The CTC method specifies tariff change rules for the imported components of each product so it can be tailored to reflect and accommodate the differing intentions which policy makers have for different products.

The CTC method generally appears more complex than a value added approach as it cannot be reduced to a simple principle or formula: the annex on product-specific rules for the US – Singapore Free Trade Agreement is 246 pages long. However, the conditions each product must meet are clearly specified and are easy to understand. The CTC method offers the possibility of a determination of origin for any given product free from administrative discretion and any significant risk of judicial review.

The CTC method of defining physical transformation has been adopted as the sole determinant of origin for a range of products in the recent Singapore-US and Chile-US agreements. Chemicals are one case where the rule consists of CTC prescriptions for each tariff classification, plus an alternative criterion, expressed at the chapter level, that allows any chemical reaction to confer origin. Neither of these criteria is associated with a regional value content requirement. So, satisfying the physical transformation rule is sufficient to establish origin.

For some items, under recent US agreements, the CTC criteria and the regional value content rules are alternatives. For other items, firms are given the option of meeting a looser CTC rule, with an additional regional value content requirement, or a more rigorous CTC rule without such a requirement. Car parts are treated this way in the US Singapore and the US Chile agreements.

3. INTERNATIONAL AND OTHER DEVELOPMENTS

Since the last review of the CER ROO in 1992, Australian industry has not expressed any significant dissatisfaction with the operation of the rule nor suggested that an alternative model should be considered. However, recent international developments have led industry to raise concerns that lack of consistency between ROO across different trade agreements will impose additional administrative burdens on exporters.

At present, ROO are fairly consistent across Australia's existing trade agreements. The CER ROO is used in Australia's other existing trade agreements such as SAFTA, the Papua New Guinea - Australia Trade and Commercial Relations Agreement (PATCRA) and SPARTECA. The CER ROO is therefore very familiar to Australian industry. It is also similar to other origin establishing criteria such as the 'made in Australia' safe harbour under the Trade Practices Act labelling provisions.

However, negotiations for FTAs with the US and Thailand are likely to result in a ROO different to that in the CER. The Government's interest in pursuing bilateral trade liberalisation, where there are benefits to Australia, makes it likely that the issue of consistency will become increasingly significant. In negotiations for an FTA with Australia, the US is expected to propose the CTC method of determining origin. The US CTC method has been adopted, with minor variations, in recent US agreements with Singapore and Chile. In the Thai FTA, a number of options for determining origin were considered, including the US CTC method. Through consultation over

the US and Thai FTAs, industry has developed a familiarity with the CTC method and has indicated broad support for this approach.

Beyond the impact of the FTAs that Australia is now negotiating with other parties, the most important change to have occurred since the CER was initiated is the reduction in most favoured nation (MFN) tariff rates in both partner countries. This reduction means that the value of the tariff preference is small for everything except passenger motor vehicles and textile clothing and footwear. Even those sectors now enjoy very much lower MFN protection than applied in 1983.