

**SUBMISSION TO THE  
AUSTRALIAN PRODUCTIVITY COMMISSION  
ON**

**AUSTRALIA AND NEW ZEALAND  
CLOSER ECONOMIC RELATIONS TRADE  
AGREEMENT  
RULES OF ORIGIN**

**FROM THE MINISTRY OF ECONOMIC DEVELOPMENT,  
THE MINISTRY OF FOREIGN AFFAIRS AND TRADE, AND  
THE NEW ZEALAND CUSTOMS SERVICE**

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# SUBMISSION TO THE AUSTRALIAN PRODUCTIVITY COMMISSION ON AUSTRALIA AND NEW ZEALAND CLOSER ECONOMIC RELATIONS TRADE AGREEMENT RULES OF ORIGIN FROM THE MINISTRY OF ECONOMIC DEVELOPMENT, THE MINISTRY OF FOREIGN AFFAIRS AND TRADE, AND THE NEW ZEALAND CUSTOMS SERVICE

## Introduction

- 1 The Ministries of Economic Development and Foreign Affairs and Trade, and the New Zealand Customs Service welcome the opportunity to make a submission to the Productivity Commission related to its current review of the ANZCERTA (otherwise known as CER) Rules of Origin (RoO).
- 2 In this the twentieth anniversary year of the CER agreement trade ministers from Australia and New Zealand have agreed that officials should examine the RoO to consider whether improvements which would benefit business on both sides of the Tasman can be made. Ministers agreed that the review should be guided by the following principles:
  - RoO should continue to facilitate trans-Tasman trade in goods manufactured within the combined markets and recognise the changed economic drivers as both economies seek to become more internationally competitive.
  - All genuine local content should be counted towards meeting the RoO.
  - The RoO should not act as a constraint on the development of innovative and efficient business practices within Australia and New Zealand.
  - There should be equity of treatment for all businesses, whether they are integrated manufacturers or use outsourced manufacture.
  - The RoO need to be able to be administered effectively and consistently by the Customs Services of Australia and New Zealand.
- 3 This submission is in three parts. **Part one** deals with some broader economic arguments that, in our view, provide support for liberalising the existing RoO. We see it as important that the review and design proposals be based on an analysis of the changed economic environment faced by trans-Tasman businesses in the last twenty years. **Part two** identifies key issues under the current RoO which are causing particular businesses concern and which need to be taken into account in the design of review proposals. **Part three** identifies broad design considerations which may inform the Commission's recommendations.<sup>1</sup>
- 4 In addition to the principles identified above, other key factors that will need to inform the Commission's study and recommendations include:

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<sup>1</sup> The Ministry of Economic Development commissioned the New Zealand Institute of Economic Research to undertake a study of CER RoO. This submission draws on some of the analysis contained in the Institute's study.

- the difference in scale of the New Zealand and Australian economies and the scope and depth of the manufacturing base in each;
- the anticipated changes to New Zealand's and Australia's tariff regimes over the next decade and the fact that this may well be the last opportunity to comprehensively review the RoO;
- changing business practices as businesses on both sides of the Tasman seek to become more internationally competitive;
- the fact that while the trans-Tasman market will continue to be important for manufacturing businesses on both sides of the Tasman, their growth prospects will increasingly depend on developing international markets; and
- the need for administrative simplicity consistent with the diminishing tariff preferences under CER and with the development of new Free Trade Agreements (FTAs) with third parties.

- 5 The CER RoO provide for three classes of goods – raw products, goods wholly manufactured from raw or determined products and goods partly manufactured. This submission is directed at the final category – partly manufactured goods.

#### **PART ONE: Economic Argument**

- 6 The RoO determine entitlement to CER tariff preferences. They were devised over 20 years ago when the tariff protection afforded to trans-Tasman business was high. High tariffs, import licensing and tariff quotas on both sides of the Tasman supported, and in turn reflected a high level of diverse and wholly manufactured operations. Incentives to exploit CER tariff preferences were high and there was a need to ensure that third countries did not benefit from the preferences. This was achieved by enacting and enforcing relatively conservative RoO.
- 7 It was recognised at the time that the principal driver for improving competitive efficiency in both countries' manufacturing sectors would be the removal of tariffs and quantitative restrictions. The competitive efficiency effects of progressively removing tariffs under CER far outweighed any inefficiency effects associated with the relatively conservative RoO. Indeed it could be argued that conservative RoO were a necessary trade-off for the competitive adjustment effects associated with tariff removal.
- 8 The design of the RoO, including the 50 per cent threshold, reflected a desire at the time to:
- (a) ensure that only goods that embodied considerable local content could enjoy the preference;
  - (b) ensure that only the direct value of manufacturing operations in the factory were counted and not the value of the total business operation e.g. profits and minor processes performed post-production by other entities; and

- (c) allow manufacturing sectors on both sides of the Tasman to adjust to more internationally competitive practices.

The changed tariff environment

- 9 Australia and New Zealand's average external tariffs have been significantly reduced over the last 20 years in an attempt to open domestic markets and improve the international competitiveness of our firms. Tariffs have been reduced across the board albeit at a slower pace in more sensitive sectors, such as the textile, clothing and footwear (TCF) sectors. The result is that trans-Tasman tariff preferences today are no longer the strong efficiency driver in the trans-Tasman market that they were at the inception of the CER agreement. As external tariffs have come down in both countries, they have been replaced by strengthened international price competition, including in the protected sectors.
- 10 The change in external tariff settings, contrasted against the largely unchanged RoO, have seen the RoO become an increasingly perverse constraint on the drive for increased manufacturing and broader business efficiencies not only in the trans-Tasman market but also with respect to the ability of individual firms to compete in international markets. As both countries contemplate further reductions to their tariff regimes it will become increasingly important to ensure an appropriate relationship between these tariff regimes and the demands made by the RoO, particularly in sectors where the trans-Tasman market remains of key importance to exporters.

Loss of dynamic benefits

- 11 At the inception of the CER agreement, a very high proportion of manufactured goods were wholly produced within the trans-Tasman economy, consistent with the high external tariffs that underpinned industry policy at that time. The range of manufactured goods available in terms of price, quality and choice was more limited. Today, however, lower external tariffs have led to manufacturing operations becoming less integrated to reduce costs and achieve economies of scale and improved business management. Manufacturers want to buy their inputs from the most competitive sources, including internationally, to improve their competitiveness.
- 12 Because the trans-Tasman market, however, remains very important for both countries' elaborately transformed manufactures (ETMs), the constraints of the existing RoO are encouraging distorted production and investment decisions and limiting the ability of firms to extract further efficiency gains. More importantly they are also preventing the use of higher quality imported input materials that would enable Australasian firms to move further up the value chain in global markets. Australian exports of ETMs to New Zealand in 2002 were NZ\$4.4 billion (AUS\$3.79 billion). The US and New Zealand are Australia's largest export markets for these types of goods. For the year ending June 1999, 47 per cent of New Zealand's ETM exports went to Australia, amounting to NZ\$2.29 billion (AUS\$1.86 billion).

- 13 The relative importance of each market to the other may be an important determinant in the level of distortion caused by the current RoO. The more important the market is to a particular sector or firm, the more they will be prepared to adopt less efficient practices to meet the RoO requirements and maintain preferential tariff access. This is more likely to be the case for New Zealand firms given their higher level of dependence on trans-Tasman trade than Australian firms which have a larger domestic market.
- 14 Maximising area content levels in order to meet the qualifying threshold may now be contributing to inflated cost structures and lower quality standards in trans-Tasman trade, as firms source locally not necessarily because it's best for their product, but because of the restrictive RoO regime. Firms operating close to the threshold, who are more likely to need to adjust their manufacturing processes to ensure they meet the regional content requirement, highlight this inefficiency.

### Supply constraints

- 15 An increased level of fragmentation in production processes has occurred due to a combination of the reduction in average tariffs in Australia and New Zealand, the drive to reduce labour and capital costs, globalisation, and technological progress. New Zealand, in particular, given the scale of its economy and the size of its firms, may have been more susceptible to these developments. This may have had, and may continue to have, a direct impact on manufacturing capabilities and the way firms can add significant regional<sup>2</sup> value to exported final goods.
- 16 The lack of manufacturing infrastructure and depth in New Zealand, in comparison to the Australian market, has led to genuine concern that production could be restricted due to limited availability of either domestically produced inputs or those manufactured in Australia. Firms have indicated that often it may not be economical to look to Australia for inputs. This concern is valid for all sectors of the New Zealand economy including sectors that enjoy a relatively high level of protection, such as TCF.
- 17 The Australian market by comparison is represented by larger scale manufacturers who have the capacity to integrate production processes or can outsource these activities to Australian producers of intermediate goods. Nevertheless they may also experience inefficient supply side constraints.
- 18 Firms now contract out the production of inputs or specific tasks that previously they would have undertaken themselves. This has been an essential move by many companies to maintain competitiveness through reducing costs and recognising the role of specialisation in the developing global marketplace. It has accordingly become increasingly more complex to satisfy the existing RoO as the stages of production of the final good are spread between more and more suppliers, many of whom in turn sub-contract out work. The corollary to this has been the increased difficulties by Customs in validating area content.

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<sup>2</sup> "Region" in this paper is used as meaning the Australia-New Zealand free trade area.

- 19 These supply side constraints and the growing value of international markets to trans-Tasman firms suggest that there will come a point when the drivers to be competitive in the global market will outweigh any benefit afforded by the decreasing margin of trans-Tasman preference. At this cross over point firms may elect to forgo trans-Tasman preference and be willing to incur a duty to pursue larger third markets. This scenario raises the question of whether there is a tariff point at which it may be more efficient to remove any RoO requirements on the grounds that they have become no more than a direct cost to consumers.
- 20 The above suggests a case for a more liberal approach to RoO for sectors that currently face a low level of tariff protection. The case, however, may also be supportable in relatively highly protected sectors. More liberal RoO would lessen the disincentive for the protected sectors to move up the value chain in the interest of their long term sustainability. In the TCF sector on both sides of the Tasman there is some evidence that firms are constrained from achieving this shift under the current regime. The current RoO, based on ex factory cost, fail to account for changing consumer demand for broader ranges of fabric styles and designs. Consumers are demanding high quality and more expensive fabrics. Those high fashion and niche market clothing manufacturers that elect, for example, to source fabrics from international markets, put at risk their trans-Tasman tariff preference as the fabric cost accounts for a larger proportion of the overall cost.

### Capturing dynamic gains

- 21 Another economic argument for the reform of the current RoO is the lack of focus on capturing dynamic gains from trade. The broader dynamic issues include:
- **Technological innovation:** supporting the acquisition of new technology and innovation in manufacturing production is critical for both Australian and New Zealand producers in becoming more internationally competitive. The current RoO may impede innovative practices and the ability to shift into higher value markets and activities. Economic returns are accordingly lower than they might be. To the extent that this is the case, the RoO may be acting as an increasing constraint on the acquisition of new technologies that would improve the long run competitive position of Australian and New Zealand firms internationally.
  - **Gains in factor productivity:** inefficient allocation of resources in production can lead to less than optimal productivity. Reformed RoO should support further efficiency gains by allowing for better utilisation of labour and capital.
  - **Allocative efficiency gains:** some trade creation may still be taking place under the current system. The more likely impact of the existing RoO, however, is increasing trade diversion away from the more efficient producer of inputs. Over time these declines in allocative efficiency could lead to more general production inefficiencies.
  - **Market enlargement:** reform of the RoO must focus not only on promoting support for further high value added trade within the trans-Tasman market but also support the development of markets outside of the region. Under the RoO the allocation of overhead costs are pro-rated across all markets for the

purpose of calculating qualifying origin. The perverse situation has arisen where, for example, a New Zealand company growing its operations in the US market puts its preferential access into Australia at risk because it is required to pro-rate an increasing proportion of its overhead costs to the US operation. This diminishes the proportion that can be counted towards trans-Tasman qualifying origin and hence lowers the area content level.

- **Investment efficiency:** distortions that are created by the current RoO also impact on investment decisions. Incorrect signals and price distortions to producers lead to inefficient purchasing and investment decisions, or the deferral of productive investment. This will make producers less competitive in the trans-Tasman market, but just as importantly potentially less competitive internationally.

A further diversion from efficient investment may occur where producers of a final good, comprised of third country inputs, cannot under the current threshold extract investment efficiencies and decide to relocate to the largest market in the region to extract efficiencies of scale. In this case investment can be channelled toward a more inefficient producer in the long term.

22 It is important that the reformed RoO ensure the broader dynamic implications as outlined above are taken into account. Any modifications to the RoO must seek to minimise trade diversion and allow for dynamic gains to be realised in the context of changes to Australia's and New Zealand's tariff policies over the coming years.

23 We invite the Commission to focus on:

- the implications of the reduction in tariffs for manufacturing practices in New Zealand and the implications of this for New Zealand firms' ability to compete in the larger Australian market under the current RoO;
- how the current RoO may be restricting New Zealand firms' ability to capture efficiency gains in the light of the overall shift away from large scale manufacturing (with the exception of large scale primary product manufactures) and the threat of import competition from large overseas producers compounding the minimum scale efficiency required for new manufacture; and
- how the RoO should reflect the move to more fragmented production operations in support of the development of high value niche markets in Australia and globally in response to international competitive pressures.

## **PART TWO: Key Issues with the Current Value Added RoO**

### *Other economic considerations for modifications to RoO*

24 The potential negative economic impacts of the existing RoO outlined above may be exacerbated by the fact that an increasing proportion of trans-Tasman trade is undertaken close to the 50 per cent threshold and is, therefore, vulnerable to losing tariff preference given the specific design characteristics of the CER RoO.

- 25 Businesses on both sides of the Tasman have identified a number of serious concerns associated with the current RoO design under which substantial transformation is identified by value added content based on ex factory costs. Some of these, including the treatment of outsourcing and intermediate materials, are currently being addressed by the two governments. For completeness, however, we reiterate them below.

*Integrated versus outsourced operations*

- 26 The CER value added RoO regime is anchored in the concept of an integrated factory. The RoO qualifying costs are determined by the costs associated with the last place of substantive manufacture (substantial transformation) – i.e. ex factory cost. This has become an increasingly narrow construct in the context of modern business practices and the trend towards businesses outsourcing their manufacturing operations in the drive for increased competitiveness. Substantive local content undertaken by the principal business fails to qualify towards local area content under the model. Given the increasing competitive pressures that businesses are under, and the fact that rationalisation of their operations has put them at increasing risk of falling below the 50 per cent qualifying threshold, the constraints of the current ex factory cost model have become all too evident to many trans-Tasman businesses. The ex factory cost last process requirement is not a feature of other countries' FTA RoO.
- 27 Should the Commission continue to recommend a build-up value added approach to CER RoO, we would invite it to explore the benefits of moving to a definition of principal manufacturer in keeping with Australia's practice under its FTA with Singapore and the practices under other FTAs.

*Treatment of design and overheads where provided free of charge*

- 28 The ex factory cost measure excludes much local content and economic value added under modern business practice where the "principal manufacturer/exporter" outsources all the substantial manufacturing operations. The current RoO, in most instances, do not allow for design and overhead costs to be captured, where the "principal manufacturer" provides these free of charge to the factory which undertakes the last process of substantive manufacture. Considerable valuable local content is therefore unable to be counted towards meeting the qualifying threshold.

*Treatment of overheads*

- 29 The current RoO require that overhead costs, in relation to production, be pro-rated between trans-Tasman trade and international trade. While the logic of this under a static scenario may be supported, it provides a significant constraint under a dynamic scenario. Successful trans-Tasman companies are, perversely, faced with reducing their qualifying overhead costs if they grow their international markets faster than their trans-Tasman markets. Given that many successful trans-Tasman companies' long-term strategies are based on global growth strategies, the RoO are acting as a constraint on further business rationalisation for companies operating close to the qualifying area content threshold. This is



particularly the case where the trans-Tasman market is today a company's most important market. The RoO accordingly penalise a company which seeks to use its trans-Tasman market base as a platform for global expansion.

#### Treatment of capital cost

- 30 The RoO advantage companies that carry considerable debt. Interest costs are an allowable qualifying expenditure. Low geared companies, however, which fund investment from internal funds are unable to impute a cost of capital as a qualifying expense towards meeting preference.

#### Treatment of profits and overheads

- 31 The RoO provide that profits of the factory of last process of substantive manufacture are disallowed. Most overheads of the factory are, however, allowed but with some significant exemptions.
- 32 The treatment of profits and overheads between fully integrated manufacturing operations and those businesses that outsource the production of intermediate materials, however, is inequitable on a number of grounds. The profits and overheads, including transport costs, associated with the manufacture of intermediate goods and materials by outsourced operations can be counted towards the qualifying expenditure of the factory undertaking the last process of substantial manufacture, on the basis of there being an invoiced price for the material. Moreover, if the area content of an outsourced operation producing the intermediate goods meets the qualifying area content threshold of 50 per cent, this may be bulked up to 100 per cent area content. If the area content falls below the 50 per cent threshold, qualifying costs of the outsourced intermediate goods production, including profits and overheads, is calculated on a pro-rated basis.
- 33 An integrated operation, on the other hand, with separate intermediate material design, production and cost centres, is unable to impute profit, unless it can prove that the relationship is fully arms length. While counter to the general trend some large manufacturing firms in New Zealand have moved to integrate their operations in light of the closure of smaller intermediate material production firms as external tariffs have been reduced. They have accordingly been disadvantaged in doing so under the existing RoO.

#### Exchange rate volatility

- 34 Fluctuations in the value of the New Zealand and Australian dollars can have significant impacts on exporters trying to gain preferential market access under the CER RoO. The implications of exchange rate volatility were not anticipated at the time of the RoO's original design.
- 35 A declining New Zealand dollar for the larger part of the last decade meant that the cost of the imported component or raw material as a proportion of total costs rose considerably. While there is short term tolerance level of up to 2 percentage points around the 50 per cent area content requirement on individual shipments, this was neither designed for, nor capable of, dealing with the significant volatility

of exchange rate fluctuations. Discussions with firms suggest that the exchange rate impact has had two effects. One is that it has resulted in many firms now operating very close to the area requirement threshold and facing the possibility that any further adverse exchange rate fluctuations could see them lose their tariff preference. The other effect is to oblige firms operating close to the threshold to defer further productivity enhancing measures or to add unnecessary domestic content or purchase unnecessary high cost domestic inputs to ensure that they continue to qualify under the RoO.

- 36 While some producers will be more susceptible to a volatile exchange rate, if shifts in the exchange rate are significant enough, volatility is likely to be an issue even for larger producers. If producers are locked into long term contracts with foreign suppliers, vulnerability in terms of exchange rate is heightened and many producers become attached to inefficient sources of input.

### Compliance costs

- 37 The current RoO require the maintenance of detailed factory records and have generated a complex and costly administrative environment both for manufacturers to comply with and for Customs to enforce. Changing business practices have in turn made this more complex, particularly for Customs administrations. Having said this, any anticipated improvement in compliance costs under a reformed regime would need to be weighed against the value of being familiar with existing systems.

### The treatment of intermediate goods that are not produced in either country

- 38 Currently all imported intermediate materials even if they are not made in either country and attract a duty free tariff concession are counted against the area content in the RoO calculations. If preference on a final product is denied and the product traded over the tariff, the effect is to apply a discriminatory tax on the intermediate good in trans-Tasman trade, compared to the rest of the world. While the indirect effects on final goods trade of discounting these intermediate materials from the RoO calculations may need to be addressed, this nevertheless must represent an increasingly anomalous situation in the context of the objective of improving the competitiveness of New Zealand and Australian firms.

### The threshold

- 39 The area content threshold has been identified as the single most important issue by New Zealand businesses under the current RoO. We refer the Commission to the comprehensive submission by Business New Zealand on this issue. In many respects the concerns with the current design of the RoO identified above, reflect a concern about the inappropriateness of the current threshold.
- 40 Lowering the threshold would go a long way towards dealing to the risk that many competitive trans-Tasman businesses face today of failing to qualify for preference. Due to commercial sensitivities hard evidence is difficult to come by. Anecdotal evidence leads to the assumption that an increasing proportion of businesses are at risk of losing their tariff preference, or are trading on the basis of

the odds being in their favour that they will not be subject to Customs investigation. If this is the situation, then the case for directly lowering the area content under any reformed value added model is compelling. New Zealand recognised the merit in lowering the area content threshold in its agreement with Singapore, as well as the need to identify new ways to capture genuine local content currently denied under the CER RoO.

### **PART THREE: Specific Design Considerations Under A Reformed Model**

- 41 This part broadly reviews the advantages and disadvantages of other approaches to RoO under different FTAs which the Commission will want to take into account. The objective should be to design a dynamic, fit for purpose, regime that meets the objectives identified by CER Ministers in their Joint Ministerial Statement this year. Any revised model should be capable of serving CER over the next decade and therefore must take into account anticipated possible changes in both countries' tariff regimes. It must also take into account developments internationally under FTAs and the likely impact that the different treatment of RoO under them may have for integration and the efficient administration of CER RoO.
- 42 Preferential regimes and free trade areas adopt a wide variety of RoO. Within this variety some models seek to maximise local content and indirectly protect local manufacturers of final goods from import competition, and others give more balanced recognition to exporter interests within the free trade area.
- 43 Under most rules the wholly obtained criteria for determined origin by and large are fairly consistent or at least non-controversial.
- 44 The substantial transformation criteria to determine products of mixed origin however are more varied and include the following:
- Change in Tariff Classification (CTC): This requires a change to be made to the product, which results in a change in tariff classification at the 2, 4 or 6 digit level (change in chapter, heading or sub-heading respectively). A change at the Chapter level is a much more substantial change than a change at heading or sub-heading level (see below).
  - Value Content (VC): The content can be a minimum regional value content requirement (RVC), maximum import content (MC) or value of parts (VP) requirement. This can be achieved by either a build-up process or build-down process (removing the value of the non area content from the final value).
  - Technical Requirement (TECH): This requires a certain process to be undertaken in the country of origin.

#### EU Rules of Origin

- 45 The RoO across the EU's free trade areas are primarily based on a change of tariff classification, typically at the heading (4 digit) level, but with many exceptions. These CTC rules may be combined with a technical test and/or a varying value content requirement on a factory selling prices basis.

- 46 There is little variation between the various EU agreements in terms of RoO, reflecting a drive to harmonize the existing and future preferential regimes. Work on aligning the various regimes resulted in the 1997 launch of the PANEURO (Pan-European) system that established identical protocols for RoO, and product specific rules for the existing agreements.<sup>3</sup>

#### Rules of origin under NAFTA

- 47 The primary regime under NAFTA is also a change in tariff classification. However the rules adopt a product specific approach. The CTC rule may be a change at the chapter, heading, sub-heading, or even national tariff item level (8-10 digit). Moreover, these are often combined with a technical or regional content requirement on a product by product basis. A similar approach is taken in the US bilateral FTAs with Singapore and Chile. The CTC rules are often stricter than the EU CTC approach with a much greater tendency to require a full change of HS chapter.
- 48 A number of longer standing agreements involving the Americas (e.g. LAIA – the Latin American Integration Agreement) like CER use a general rule, rather than product by product rules. LAIA requires a CTC at the heading level or alternatively regional value added of 60 per cent (FOB basis).

#### ASEAN rules of origin

- 49 The basic requirement to determine origin within ASEAN is for 40 per cent of the FOB value to be ASEAN content. There is an additional requirement that the final process of the manufacture is performed within the territory of the exporting member state.<sup>4</sup>

#### Mercosur (Mercado Comun del Sur – Southern Common Market) rules of origin

- 50 The requirements for Mercosur are based on a change in tariff classification (heading), of 50 per cent regional value content requirement for certain products on FOB value.<sup>5</sup> Some products can be subject to technical and other requirements.
- 51 The following table considers the three main systems in terms of the features mentioned above, and some more general advantages and disadvantages. It takes into account previously discussed issues arising in the New Zealand context as well as information from international examples of such systems.

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<sup>3</sup> “Rules of origin: A world map and trade effects”, Estevadeordal and Suominen, May 2003

<sup>4</sup> <http://www.aseansec.org/10149.html>

<sup>5</sup> <http://www.isen.gov.ar/sdt/DT0025nx.htm>

Table 1 Advantages and Disadvantages inherent in three systems

|                   | Advantages   | Disadvantages  |
|-------------------|--|--|
| Regional Content  | Simplicity/Precision   | Encourages producers to resist productivity improvements and creates incentive to produce inefficiently  |
|                   | Encourages uniform requirements for all products                                 | Substantial compliance and administrative costs  |
|                   | Generally comprehensible   | Penalises low cost producers   |
|                   | Easy to measure economic impact  | Vulnerable to exchange rate changes, particularly for those operating close to the threshold   |
|                   |  | Inconsistent results across products. Not necessarily a common threshold across products   |
| CTC               | Inherent predictability (origin status certain)                                  | Harmonised System is not designed for origin conferral purposes. It is often necessary to allow for exclusions from the general rule e.g. a mix of CTC and value content |
|                   | Not susceptible to exchange rate changes   |  |
|                   | Allows for dynamic efficiency gains, focus on change in the state of the product | Maybe high initial compliance costs establishing changed rules   |
|                   | Does not discriminate against low cost producers                                 | Especially open to industry capture, through systems of exceptions to rule e.g. "Change of Tariff Heading except from headings X Y and Z"                                |
|                   | Conceptually simple/easy to understand if exceptions are limited                 | Susceptible to changes in technology and to the HS nomenclature  |
|                   | Ease of enforcement – simple to verify compliance                                |  |
| Specified Process | Same as for CTC  | Open to industry capture/highly subjective mechanism   |
|                   |  | Changes in technology /business practice can render obsolete   |
|                   |  | Tendency to lock producers into particular production scenarios  |
|                   |  | Encourages creation of highly tailored rules/inconsistency between like products   |

- 52 In comparing the benefits of the systems it would be useful to undertake some analysis of the implications for ETMs, particularly where high levels of tariff are still present and where there are high levels of trans-Tasman trade. In looking at a CTC model the effect it will be necessary to consider the effect of the different changes in chapter, heading, sub-heading etc.
- 53 The scope for different approaches within the CTC system will deliver considerably different outcomes. A change of Harmonised System (HS) chapter requirement, common in the NAFTA, represents a much more substantial transformation than a change in the tariff heading or, especially, a change in sub-heading. Accordingly, the impact of a CTC system on conferring RoO can vary substantially. A chapter change requirement is often difficult to achieve and may be impossible (for example, most dairy products, from milk to fully processed products, are classified within a single HS chapter. A chapter change rule for HS chapter 4 would deny exporters the chance to use foreign dairy materials). Conversely, a change of sub-heading rule is extremely liberal since it may involve very little “transformation”.
- 54 Exceptions under a CTC regime should ideally be limited to cases where the harmonised system of tariff nomenclature either would allow origin to be conferred too readily e.g. by freezing a fish, or where it would not allow for ready origin conferral, e.g. a strict change of tariff heading rule would not recognise assembly of a machine from parts classified in the same tariff heading. Such exceptions should however be kept to the minimum required for technical reasons linked to the structure of the HS.
- 55 An FOB approach under a value added model would facilitate origin conferral. The FOB price generally forms the basis for valuing goods for duty purposes and, as such, is always known for goods-entry purposes. Using FOB would allow for additional costs to be taken into account, including a full new range of labour and overhead costs and a “reasonable” manufacturer’s profit. The FOB measure would remove distinctions between integrated and outsourced manufacture, which are impossible to justify in logic and which create a new layer of economic distortion. It would also remove any distinction between “The Factory” where the last process took place and other entities contributing to the value of the final export good. An FOB rule would assist manufacturers and would be much more consistent with the way in which business is required to operate today in response to competitive pressures.

Criteria that should inform future design

- 56 We invite the Commission to take into account the following principles in proposed changes to the CER RoO:
- The revised RoO should encourage productivity and efficiency gains within the trans-Tasman market and support New Zealand and Australian firms drive to become more internationally competitive.

- The proposed changes should be underpinned by a clear understanding of trade flows and the implications for specific sectors.
- The measures of substantial transformation should be simple, transparent and predictable.
- Any substantive change in approach, such as a move from value added measures of substantial transformation to CTC, must be a significant advance over the current regime and be consistent with internationally acceptable approaches.
- A preference should be shown for generally applied rules rather than product specific rules in keeping with the overall principles of the CER Agreement.
- There is a need for simplicity and low compliance costs for firms and Customs administrations. The Commission will want to weigh the benefits of possible lower compliance costs under any new regime against the benefits of marginally amending existing systems which are well understood by firms.
- The RoO should be predictable and based on transparent rules and processes.
- The value of building in automatic adjustments to the RoO to take account of expected changes to the external tariff regimes of both parties over the next decade and to allow for increased dynamic gains to be realised should be considered.
- The RoO should be less susceptible to external exchange rate shock.

## **Conclusion**

57 This submission has deliberately not identified a specific policy or design position on the RoO. Rather it invites the Commission to critically look at the economic arguments that now support reform of the rules and to focus on some key design issues. The economic environment confronting trans-Tasman businesses today is markedly different from that of twenty years ago. New Zealand and Australian companies' success in competing and growing their exports internationally will be dependent on their ability to extract operational efficiencies and to move up the value chain. To the extent the trans-Tasman market remains a significant market for our respective elaborately transformed goods, the rules that govern preferential access under CER over the next decade will be either an unnecessary constraint on business performance and opportunity or an enabler. In our view the current RoO are becoming an increasing constraint. We look forward to the Commission's recommendations on their reform.