The Hon Mark Vaile MP

Minister for Trade
Deputy Leader of the National Party of Australia

15 OCT 2003

Mr Paul Gretton
Assistant Commissioner
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

Dear Mr Gretton

I am pleased to attach for the Commission's consideration a submission to the study on Rules of Origin under the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA).

This submission seeks to inform the Commission of the current state of consultations between Australia and New Zealand on CER Rules of Origin, including the agreement of both countries that certain improvements should be instituted for the benefit of businesses on both sides of the Tasman. The submission also describes the difficulties faced by some Australian exporters in gaining preferential access to the New Zealand market, and deals briefly with international developments relevant to the design and implementation of Rules of Origin.

Yours sincerely

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DEPARTMENT OF FOREIGN AFFAIRS AND TRADE SUBMISSION TO THE PRODUCTIVITY COMMISSION STUDY OF AUSTRALIA'S RULES OF ORIGIN ARRANGEMENTS UNDER THE AUSTRALIA-NEW ZEALAND CLOSER ECONOMIC RELATIONS TRADE AGREEMENT (ANZCERTA)

The Australian Government asked the Productivity Commission to undertake a research study to examine the issue of Australia's Rules of Origin (ROO) arrangements under ANZCERTA (otherwise known as CER).

This submission seeks to inform the Commission of the current state of consultations between Australia and New Zealand on CER Rules of Origin, including the agreement of both countries that certain improvements should be instituted for the benefit of businesses on both sides of the Tasman. The submission also describes the difficulties faced by some Australian exporters in gaining preferential access to the New Zealand market, and deals briefly with international developments relevant to the design and implementation of Rules of Origin.

THE CURRENT SITUATION

Since late 2002, a number of Australian clothing manufacturers have had their exports to New Zealand subjected to 19 per cent tariff duties as a result of "random alert" audits conducted by the New Zealand Customs Service. The audits have revealed that because the Australian clothing manufacturers outsource their final process of manufacture, they do not meet ANZCERTA's 50 per cent local content requirement as it is implemented by New Zealand, even though the underlying Australian local content may exceed 50 per cent.

This application of tariff by New Zealand Customs has highlighted a significant divergence in the way that Australia and New Zealand implement CER ROO, and has brought about a number of exchanges between the Australian Minister for Trade, the Hon. Mark Vaile, and his New Zealand counterpart, the Hon. Jim Sutton.

At the CER 20th Anniversary Ministerial Forum held in Sydney on 28 August 2003 (see attached Joint Ministerial Statement), the Trade Ministers agreed that under the CER, there should be equity of treatment for businesses on both sides of the Tasman, whether they are integrated manufacturers or use outsourced manufacture, and that all local content should be counted towards meeting the ROO.

The Joint Statement commits New Zealand to amend its regulations to bring about equity of treatment for outsourcing manufacturing processes, and states that both parties will move to ensure a consistent approach. At the behest of New Zealand, the Statement includes a commitment to implement changes so that 'imported intermediate goods will be appropriately disregarded from the calculation of the total cost of the finished good for the purpose of calculating local content under the CER'. It also foreshadows the establishment of a Joint Customs Committee to ensure a harmonised approach to the manner in which CER rules are administered.

The CER Rules of Origin

ANZCERTA's ROO provisions are expressed in such broad terms that there can, and have been, differing interpretations by Australia and New Zealand. ANZCERTA states that for goods partly manufactured in Australia or in New Zealand, the following conditions apply for preferential entry:

- the last process of manufacture must occur within the trade partner; and
- the goods must attain a local content of at least 50 per cent, on a "factory or works cost" basis.

An attachment to the *1992 Review of CER* also provides that

> For the purposes of Article 3 [of the CER], factory or work costs covers the expenditure which is incurred directly by the manufacturer in the production of the goods, *or* which can be reasonably allocated to the production of the goods.

The "manufacturer" is defined in the *1992 Review of CER* as the 'person who undertakes the last process in the manufacture of the goods'.

Outsourcing

The legislation designed by both countries to implement the CER ROO was devised at a time when all phases of a manufacturing process were undertaken within the one business. Today, manufacturing increasingly involves outsourcing. While the CER ROO adequately encompasses most outsourcing situations, Customs authorities in both countries have agreed that the current legislative approach does not adequately address the situation where a business outsources the last process of manufacture.

The current approach allows the labour and overheads incurred only at the place where the last process of manufacture was performed (the "factory") to be included in the calculation of local content. All other labour and overheads, including those incurred by the primary manufacturer, are disregarded, i.e. they are not included in the local content or in the total content.

Under New Zealand legislation, the value of all materials used in the manufacture of the goods is taken into account, regardless of whether the "factory" incurs the cost for them. New Zealand's "Special provisions for allocation of expenditure" require that where any material has been provided to the manufacturer "free of charge or at a reduced cost" (as is the case when outsourcing the final stage of production), such expenditures are to form part of the total factory costs of the goods,[1] hence making it more difficult for Australian manufacturers to satisfy the local content threshold.[2]

Under Australian legislation, only material costs incurred by the factory (or those materials provided free of charge or at a reduced cost by the eventual importer of the

[1] *New Zealand Customs and Excise Regulations 1996*, Reg 38.

[2] Where foreign materials are used by Australian clothing manufacturers, the value of those materials can often exceed the labour and overheads costs of the "final" factory. This can render Australian goods ineligible for preferential treatment, thereby subjecting them to 19 per cent tariff duties, even where the last process of manufacture is outsourced to factories within Australia.

finished goods)[3] are considered when determining local content and total content, so that all other material costs are disregarded, including the material costs incurred by the outsourcing business. Section 153D of the *Customs Act 1901* reads:

> (1) Subject to the exceptions set out in this section, the allowable expenditure of a factory on materials in respect of preference claim goods is the cost to the manufacturer of those materials in the form they are received at the factory…

An outsourcing business will not *charge* the "factory" for providing the materials necessary to complete the last process in the line of manufacture, so that the cost of those materials is effectively excluded from the calculation of local content. This rule also applies to "contributing materials" sourced from outside the qualifying area.[4]

As a result of the application of the Australian provisions to a situation in which the final process of manufacture is outsourced, goods will almost always meet the 50 per cent rule, including where foreign material costs exceed the combined labour and overhead costs of the factory and the outsourcing business. This is because the costs incurred directly by the final "factory" or "manufacturer" normally relate only to their own labour and overheads, which are all local content.

Put simply, the New Zealand regulations make it much more difficult to qualify for preferential access than the Australian legislation.

At the CER 20th Anniversary Ministerial Forum in late August 2003, it was agreed in the *Joint Ministerial Statement of Rules of Origin* that 'while New Zealand will move first to amend its regulations, the intention of both parties is to move to a consistent approach to outsourcing in the context of a comprehensive package of ROO reforms'. DFAT strongly supports the intent of the Joint Statement to ensure equality of treatment of genuine local content under ANZCERTA.

Intermediate goods

As part of the package of ROO reforms, New Zealand has also requested a reconsideration of the treatment of "intermediate" goods for the purpose of calculating local content. Proposed changes would disregard (up to a limit) the value of imported materials not produced in Australia and New Zealand from the calculation of local content.

Australian industry representatives have expressed concern at the prospect of a change in the treatment of intermediate goods under the CER. In particular, the Textile and Fashion Industry Association (TFIA) is concerned that the proposal on intermediate goods could open the way for a flood of imports of finished goods (eg. men's finished suits, trousers and jackets) that are produced using non-area trims and linings, and that currently lie close to the 50 per cent threshold. DFAT is of the view that proposals for change in the treatment of intermediate goods will need to be considered both in light of the likely impact on Australian industry sectors and possible economy-wide implications.

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[3] *Customs Act 1901*, Section 153E(6).
[4] *Customs Act 1901*, Section 153D(4).

RULES OF ORIGIN IN THE WORLD TRADE ORGANISATION (WTO)

The WTO *Agreement on Rules of Origin* sets out a work program (the 'Harmonised Work Program') to develop a single, harmonised set of rules of origin for use in non-preferential commercial policy instruments, such as in the application of GATT provisions on: most-favoured–nation (MFN) treatment; anti-dumping and countervailing duties; safeguard measures; origin marking requirements; and any discriminatory quantitative restrictions or tariff quotas.[5] The work program is based on a set of general principles, including that when more than one country is concerned in the production of a certain good, origin should be conferred on 'the country where the last substantial transformation has been carried out'.[6] Other general requirements are that the rules of origin should be 'objective, understandable and predictable', based on a positive standard, and that 'they should not themselves create restrictive, distorting or disruptive effects on international trade'.

The *Agreement on Rules of Origin* stipulated that the Harmonised Work Program should be completed within three years of initiation, ie. by 20 July 1998. Due to the complexity of many of the underlying issues, the time schedule has been extended, with the latest extension being to 1 July 2004. Agreement has been reached on a large number of harmonised rules of origin, but overall agreement has been delayed pending agreement on 94 outstanding 'core policy issues' and debate over the scope of application of the harmonised rules.

APPROACHES TO ROO UNDER OTHER FREE TRADE AGREEMENTS (FTAS)

Singapore - Australia Free Trade Agreement (SAFTA)

Chapter 3 of the SAFTA establishes Rules of Origin, including certification processes, to ensure that preferential treatment provided by Australia is limited to goods of Singapore origin, and vice-versa.

For goods not wholly obtained or manufactured in one of the Parties, origin is conferred where a local content of 50 per cent is achieved. For a limited number of electrical and electronic products, and for products subject to Tariff Concession Orders (TCOs), the local content threshold is 30 per cent. Local content is calculated on the basis of "accumulation", except for a range of products including textiles, clothing and footwear, passenger motor vehicle items and jewellery.[7]

Under the SAFTA, local content is calculated by reference to costs incurred by the "principal manufacturer", defined as 'the person in the territory of a Party who performs, *or has performed on their behalf*, the last process of manufacture of the goods'. These provisions have the effect of drawing into the calculation of total and local content all material, labour and overhead expenses incurred by the 'principal manufacturer', regardless of the stage of production or whether the production is outsourced or not.

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[5] WTO *Agreement on Rules of Origin*, article 1.
[6] WTO *Agreement on Rules of Origin*, article 9(1)(b).
[7] "Accumulation" takes account into account value added at all stages of the production process in one country when the manufacturing process is interrupted by offshore processing, provided that the material in question remains in the control of an individual manufacturer before and after offshore processing.

Free Trade Negotiations with the United States and Thailand

Negotiations are currently underway towards the possible conclusion of Free Trade Agreements (FTAs) with both the United States of America and Thailand. It is too early to comment on the rules of origin that are likely to emerge from those negotiations.

CONCLUSIONS

Australia and New Zealand have agreed on the need to improve the administration of CER Rules of Origin through amendment and harmonisation of their respective legislative and regulatory provisions. Australia and New Zealand have also recognised the need for a broad and ongoing process of ROO review, and the identification of other 'issues for potential early harvest'. The Productivity Commission examination of ROO will fulfil the need for such a broad review.

DFAT also supports the process agreed by Ministers on 28 August for a process of review with a life-span beyond the Productivity Commission exercise. It is intended that a final joint report containing officials' recommendations on elements of a possible comprehensive package of ROO reforms will be presented to Ministers in June 2004. The outcomes of the Productivity Commission's study of CER ROO will provide an important input to this process.

The Department is concerned that the outcome of any review of ANZCERTA ROO should be supportive of Australian business in the development of trans-Tasman trade. The experience with outsourcing of the final process of production demonstrates the ongoing need for close cooperation to achieve the harmonisation of Australian and New Zealand ROO regimes.

Future examination of the operation of CER ROO will also necessarily take into account new approaches that emerge from the WTO Harmonised Work program and possibly from other bilateral free trade negotiations.

Attachment A

Joint Ministerial Statement on Rules of Origin

The Australian Minister for Trade, the Hon. Mark Vaile, and the New Zealand Minister for Trade Negotiations, the Hon. Jim Sutton, have agreed that officials from Australia and New Zealand should examine CER Rules of Origin (ROO) with a view to considering whether improvements which would benefit businesses on both sides of the Tasman should be made. In their work, officials will be guided by the following principles:

- ROO should continue to facilitate trans-Tasman trade in goods manufactured in the Free Trade Area 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

Officials will henceforth consult regularly for this purpose, and will jointly report to responsible Ministers on progress. The first such report will be made by end December 2003, the second by end March 2004. The third and final joint report due in June 2004 will contain the conclusions of officials' deliberations, and recommendations to Ministers on elements of a possible comprehensive package of reforms.

These deliberations will take place in parallel with the Australian Productivity Commission's review of Rules of Origin and may inform or be informed by that process or any other appropriate example or independent study of ROO regimes.

Consistent with the desire to ensure ROO do not act as a constraint on trans-Tasman trade, Ministers have agreed upon a number of incremental improvements to the current system which should improve the situation for businesses on both sides of the Tasman in the short to medium term. Officials have therefore been tasked to design, without delay, changes to the ROO which, when implemented, will ensure:

- Equity of treatment for outsourcing manufacturing processes in both Australia and New Zealand. While New Zealand will move first to amend its regulations, the intention of both parties is to move to a consistent

approach to outsourcing in the context of the comprehensive package of ROO reforms;

- That imported intermediate goods will be appropriately disregarded from the calculation of the total cost of the finished good for the purpose of calculating local content under the CER; and

- The establishment of a Joint Customs Committee to ensure a harmonised approach to the manner in which rules are administered.

Officials are also encouraged to identify other issues for potential early harvest as their broader examination of ROO continues. Such issues might include sensitivity to exchange rates, apportionment of overheads, and issues related to the equity of treatment between integrated and outsourced operations.

Sydney
28 August 2003