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Mr John Williams
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Dear Mr Williams

TFIA Submission – Productivity Commission Research Paper into the Rules of Origin under the Australia-New Zealand Closer Economic Relations Trade Agreement

The Council of Textile and Fashion Industries of Australia Limited (TFIA) welcomes the opportunity to provide comment on the research study into the rules of origin as they operate under the Australia-New Zealand Closer Economic Relations Trade Agreement.

New Zealand represents a significant market and competitor for the Australia Textiles, Clothing and Footwear (TCF) sector. The effective maintenance of the rules of origin under the agreement remains a critical concern of the TFIA and its members.

The TFIA supports the operation of the rules of origin as they are applied by Australia and as such recommends that no change be made to threshold '50% rule' for determining origin. The TFIA does express concern with elements of the rules operation including the application of them by New Zealand authorities, aspects of the Determined Manufactured Raw Materials definitions and an ability for manipulation of the rules given differences in tariff schedules and manufacturing profiles of Australia and New Zealand.

While there are numerous international forces at play globally for the TCF sector the TFIA maintains that the CER approach is the best option for the current agreement and places Australia in a position to move to a harmonised rules of origin system when finalised.

The accompanying submission to this letter addresses these and other issues in more detail.

I look forward to the Commissions response on this submission and its interim report. Please contact Ashley Van Krieken or myself to discuss the submission further or for additional information.

Yours sincerely

Tony McDonald
Executive Director
17 October 2003

EXECUTIVE SUMMARY

Australia's textiles, clothing and footwear and fashion industries are on the cusp of a new period of growth and development. With fair and reasonable encouragement and assistance, the industry is gradually redefining itself with a combination of the strengths from traditional operations and the opportunities arising through a modern strategic industry based on innovation, export success and greater productivity.

Australia is now one of the most open Textile, Clothing and Footwear (TCF) markets in the world. The pace of overall global reform has slowed and the use of non-tariff barriers in overseas markets has complicated historical comparisons of tariff rates. New Zealand represents a significant market and competitor for the Australia TCF sector. The effective maintenance of the rules of origin under the agreement remains a critical concern of the TFIA and its members.

The TFIA would make the following comments to the Commission:

- The CER has increased trade in textiles, clothing and footwear products between Australia and New Zealand but it has also increased the level of competiveness between the two countries

- The current method of determining preferential treatment for goods – final significant process of manufacture and the 50% rule remains the TFIA's preferred option
    - The threshold should remain at 50%
    - Change is required in legislation to make the Australian and New Zealand systems identical

- The current 3% tolerance for a Determined Manufactured Raw Material (DMRM) should not be changed
    - DMRM's should also continue to only apply under the wholly manufactured criteria

- The appropriateness of assigning a DMRM on a concessional tariff rate requires review in the context of policy by-laws

- The Commission needs to address the ability of the rules of origin to control the use of New Zealand as a conduit into Australia for intermediate goods either through differences in tariff levels and/or the application of duty drawback

- While the rules of origin outcomes in free trade agreements with Thailand and the United States and the work of World Customs Organisation are not yet complete the TFIA believes the CER rule arrangements represent the best option for the sector.

- The outcomes of this study must be considered for their potential impact on the South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA) which uses very similar rules as the CER to determine preferential entry

INTRODUCTION

The Council of Textile and Fashion Industries of Australia Limited (TFIA) is the peak industry body representing firms and organisations covering textile and clothing activities in Australia.

The industry provides 80,000 jobs[0], sales of more than $9 billion a year and new capital spending of $200 million a year. Exports are growing rapidly, with TCF&L products contributing about $3 billion to Australia's total exports. The industry represents approximately 10 per cent of all manufacturing establishments in Australia. This activity produces "feeder" benefits through other sections of the economy. For instance, it is estimated that each job in TCF&L creates 2.5 to 3 jobs in other sectors.

The industry also provides substantial employment in regional and metropolitan areas, particularly for females. Much of the workforce is particularly difficult to redeploy in other sectors of the economy.

Through the Closer Economic Relations (CER) Agreement New Zealand is both a market for Australian Textile, Clothing and Footwear (TCF) products and a competitor in domestic markets. This competition underlies the need for the sector to have an effective rules of origin policy in place to ensure that only products of New Zealand origin enter Australia duty free.

The Inquiry's terms of reference cover a wide range of issues. These, and associated questions raised specifically by the Commission, are dealt with in the remainder of this document.

Trade between Australia and New Zealand

New Zealand has traditionally been the largest export market for the TCF industry but accounts for a relatively minor share in imports to Australia compared with Asia. Based on information from the Department of Foreign Affairs and Trade (DFAT) since the CER's inception in 1983 trade in goods had increased by 589% to A$11.3 billion in 1999. The TFIA agrees that the CER in its entirety has made a positive contribution to the Australia and New Zealand economies, as does any free trade agreement. However the extent of this benefit varies significantly between products, sectors and community groups.

A review of a range of trade statistics[1] in Textiles, Clothing and Footwear between Australia and New Zealand shows the following key points:

- In 2002-03 New Zealand exported A$368 million of textiles, clothing and footwear products to Australia with Australia exporting A$298 million worth of products to New Zealand
- New Zealand imports account for less than 10% of all imports in the textiles, clothing and footwear sectors;
    - In 2002-03 Chinese imports accounted for the majority of imports (over 50% of total TCF imports and even higher for imports of clothing and footwear)

- Exports in total to New Zealand account for around a third of total TCF exports
  - In both the clothing and footwear sectors this share is above 40%

- In total since 1992-93 imports and exports of TCF products between Australia and New Zealand have grown less than total imports and exports of TCF products reflecting the changing nature of the global TCF industries. However, the fact is that Australian and New Zealand manufacturers compete against each other on price points using quality and brand aspects rather than against the cheaper bulk product coming from Asia and other developing countries.

CURRENT OPERATION OF RULES OF ORIGIN UNDER THE ANZCERTA

Under the CER agreement for rules of origin purposes there are three categories that products can meet to be considered preferential goods under the agreement:

1. Goods wholly the produce of the country (unmanufactured raw products);
2. Goods wholly manufactured in the country from one or more of the following:
   a. unmanufactured raw products (of any country);
   b. materials wholly manufactured in Australia or New Zealand or both;
   c. materials determined to be raw materials of the country; and
3. Goods partly manufactured in the country.

The TFIA remains comfortable with these categories and their associated definitions. The majority of TCF products are subject to meeting the requirements of the third category namely, that the last place of manufacture must be New Zealand or Australia and that not less than 50% of the factory and works cost must qualify as eligible expenditure (the ‘50% rule’).

The TFIA and its members support the ‘50% rule’ as it is applied by Australian legislation and the Australian Customs Service. The Council would absolutely oppose any recommendation to lower the threshold value below 50% through direct or indirect ways and means, and expresses some concern over the application of the ‘50% rule’ by New Zealand authorities, most particularly in the treatment of sub-contractors and their services.

TFIA members have noted that a problem has arisen out of differences in the legislation relating to the treatment of eligible expenditure on materials between Australia and New Zealand. Under the CER, the legislation is supposed to be applied identically however it is not.

Under the legislation Australia and New Zealand Customs services can determine a value for imported materials provided at no cost or less than the market cost to the factory if the importer of the final preference good provided them. While this may be the case, TFIA members have noted that selected goods imported from New Zealand only count the costs incurred by the manufacturer performing the last process. In exporting goods from Australia to New Zealand however, a cost has been determined and applied to such materials. In essence under the New Zealand Customs application it becomes more difficult for Australian exporters to meet the 50% threshold as the following example shows.

Consider the following hypothetical product that costs $40 in total to produce. The cost of imported materials is $25 and the design and testing, also undertaken overseas, costs $5. These are provided to the manufacturer at no cost by the importer of the final preferential good. The manufacturer adds an additional $10 to the cost through cutting and trimming.

Under Australia's application of the legislation to New Zealand exports only the cost to cut and trim is counted towards the 50% threshold as the materials have been imported and provided to the manufacturer at no cost. In this case you have a total allowable factory cost of $10 and eligible expenditure of $10 or 100% local content at the last process of manufacture, which meets the '50% rule'.

On the other hand, New Zealand authorities investigating Australian exports to New Zealand allow both the cost of cutting and trimming ($10) and the imputed cost of material ($25) to be included in the factory cost. In this case you have domestic costs at the last point of manufacture of $10 balanced against imported costs of $25 and the origin requirement is not met – $10/$35 = 28%.

While for cheaper materials this does not present such a problem it does show that it is more difficult for Australian companies to meet the origin requirements on these types of TCF exports to New Zealand. The TFIA understands that changes were made to Australian and New Zealand legislation in 1992 in an attempt to remedy this problem but have failed to do so.

The TFIA recommends that the Commission consider ways and means to ensure that the legislation is truly identical in its operation between Australia and New Zealand bearing in mind the spirit of the agreement.

Determined Manufactured Raw Materials

The industry also has some comments regarding the operation of the rules as they apply to category 2c – Determined Manufactured Raw Materials (DMRM). The TFIA agrees with the principles behind this provision recognising that there are and will be several products where neither Australia nor New Zealand can manufacture the required raw material.

The TFIA supports the 3% tolerance allowed for DMRM's in the agreement but rejects any calls to increase this tolerance level. At 3%, the tolerance allows sufficient room to account for minor constituents, such as stabilisers, colour setters and binding agents, critical to a products performance without being sufficiently large enough to substantially impact sales of those minor constituents.

The TFIA does not support any suggestions that the tolerance level be increased or that the granting of DMRM status be widened to allow application at any stage of the production process. To do so lowers the threshold of the test and calls into question the quality of the system.

Equally the TFIA does not support any suggestion that would allow the granting of DMRMs for any other rules of origin category besides wholly manufactured goods. The application of DMRMs to the third category, goods partly manufactured in the country, would act as a significant distortion to the minimum local content.

Under the DMRM system one of the two core criteria relates to the existence of a substantive duty free tariff rate or a duty concession, which may be a tariff concession in either country. Given the principle that both countries are trying to apply and the rapid movement to lower tariffs for most raw materials in both countries, the Commission should consider whether a tariff concession application is the appropriate reference now. The TFIA has some concerns over DMRM's granted for products with a substantive duty free tariff rate and equally over the granting of DMRM's to products with concessional duties applied through a policy by-law.

A concession order allows an imported product to enter the country at a reduced rate to the normal tariff level. The TFIA remains concerned however that this requirement could result in the granting of a DMRM to a product that does have production in Australia. This is due to the existence of several policy by-laws that allow for the duty free entry of imported products even where they are produced in Australia.

While the second criteria relates to there being no objection from a local manufacturer the TFIA remains concerned that the process currently followed may not allow local manufacturers sufficient time to object. In most cases where a Tariff Concession Order is granted it because there is no local production and thus the granting of DMRM status to a product is unlikely to be met with objection. A product under a policy by-law however is likely to have a domestic producer who may wish to object to the granting of a DMRM.

The TFIA would propose that where a concession exists due to a policy by-law Australian and New Zealand Customs Services should adopt a longer and broader consultation process than it does for products the subject of Tariff Concession Orders.

Intermediate Goods

Of less concern yet still an issue for this study is that of intermediate goods and the potential advantage afforded to New Zealand manufacturers. Under the CER, Australia and New Zealand have agreed to allow products that meet the preference criteria free entry into their domestic markets. This has allowed a distortion to arise whereby New Zealand acts as a conduit to the Australian market place for raw materials from third countries. This is by virtue of the differences in tariff levels and/or the application of duty drawback to goods by New Zealand and Australia.

Consider for instance the case of material for the manufacture of suits[2]. Such cloth entering Australia from any non-preferential country currently attracts a tariff of 15% while in New Zealand it enters duty free either directly or through the drawback of duty on the exported finished suit. In this case a cost advantage is provided to the New Zealand manufacturer of the suit. Under the rules of origin the 50% threshold can be met through the inclusion of labor and factory overheads, allowing the suit to be sold into Australia at a significantly lower wholesale price. This in turn places price pressure on Australian manufacturers and leads to a loss of market share.

INTERNATIONAL DEVELOPMENTS AND THEIR IMPACT ON ANZCERTA

The TCF sector is a global sector with the balance of trade having shifted from developed countries to developing economies that have and continue to increase their productive capacity and share of global trade, particularly those in Asia. In its submission to the Productivity Commission Inquiry into post 2005 assistance arrangements for the TCF sector the TFIA noted the following international trends for the sector:

- Globalisation in all its different aspects, including corporate change, supply chain development, restructuring and rationalization.
- New technologies (and organisational methodologies) and the growing importance of innovation in all its forms.
- Regulation aimed at achieving society's environmental, labour relations and occupational health and safety goals.
- The impact of emerging industries and markets such as China.
- Ongoing developments in world and regional trading rules and practices.

All of these factors impact on the domestic TCF industry and on the operation of the Closer Economic Relations Agreement between Australia and New Zealand. Given the Terms of Reference for the study this submission will focus on the first and last two dot points.

In recent years, manufacturing capabilities have shifted around the world as markets have grown. Access to markets has been used as an integral component of national aid and industrial strategies. This has seen the suppliers to the American market congregate in Mexico and the Caribbean Islands (under the NAFTA and CBI arrangements) and more recently, Africa (under the AGOA) and increasingly, South America. America is actively facilitating the utilisation of trade preference programs, encouraging the use of American textiles through the Caribbean basin and Africa. The American administration has decided that any tariff reductions must be "linked to reciprocal cuts by our trading partners, as well as to elimination of other trade distorting practices, to level the playing field."[3]

Europe has turned to Eastern Europe as its source of low-cost high-volume commodity merchandise by expanding EU membership to encompass the eastern countries (and those of the Baltic States).

Asia and in particular China continues to increase its dominance of Australian imports of textiles, clothing and footwear products eclipsing the majority of other countries. For the financial year 2002-03 Asian imports, excluding Japan, accounted for 66% of total imports with these imports growing at an average of 10% per year over the last five years. As the ASEAN Free Trade Agreement develops this growth will continue to increase.

Generally these imports tend to be low cost derivative items produced in bulk quantities rather than high value add products. However, the rate of foreign direct investment into China is fast emerging as a significant driving force for international TCF products and higher value added production.

The ability of the ANZCERTA to withstand this flow of imported products is a critical issue for the TFIA and its members. The purpose of a free trade agreement is to benefit the parties to it. Breaches of the conditions of the agreement impact the whole trade area under the agreement as well as severely impacting a particular member. Both the Australian and New Zealand Governments must work to ensure that the rules of origin under the agreement work to promote innovation and the development of products for niche markets and high-value added TCF products, as these areas are where the Australian and New Zealand industries are strongest

In respect to the last international trade dot point above there are currently several activities underway in the international arena that have relevance to the Commissions research. The first is the free trade agreement currently being negotiated between Australia and the United States, the second is the free trade agreement between Australia and Thailand, the third is the initiative by the World Customs Organisation (WCO) on non-preferential textile rules and finally the treatment of Least Developed Countries (LDC's). The outcomes of these negotiations will have significant effects for the ANZCERTA and the Free Trade Agreement recently concluded with Singapore.

Under both the Thailand and United States free trade agreements the rules of origin for textiles remain under negotiation. Under the Thai agreement four main options have been proposed:

- The final significant process of manufacture 50% factory cost method as included in the ANZCERTA;
- The 40% FOB method included in the ASEAN Free Trade Agreement; and
- A FOB method with a threshold of 55% rather than 40%
- The Change in Tariff Classification approach as used in the North America Free Trade Agreement

The TFIA preference is for the first method which follows the ANZCERTA approach for a number of reasons including its ability to reflect investment in capital and labour, in current or constant terms, to value add materials in the countries party to the FTA and its familiarity for Australian importers and exporters. In addition given the prospect that current international discussion on rules of origin may cause a move towards the United States fibre/yarn forward NAFTA method it would make sense to maintain the CER arrangement rather than significantly re-inventing it or implanting another system in its place.

While it has been argued that the factory cost analysis is a complex method the TFIA would contend that an FOB approach can be just as challenging to companies. This is due to the need to consider target rebates, returns, financing and payment options etc, which may all have an impact on the local content if determined using this price point as a determinant. In addition the use of the FOB export price as an element of the determination of preference entitlement can lead to a distortion of the local value added in manufacturing. This can occur as the gross margin or elements of it can be applied in any country to build up cost/price factors while having no effect on activity in the country party to the agreement.

Under the free trade agreement with the United States the preference has been clearly enunciated by the United States to adopt the NAFTA approach as contained in the United States-Singapore. These revolve around the change in tariff classification method supplemented by a regional content value for many items. For the TCF sector these rules are a process based approach and the TFIA and its members are still working through the rules to fully understand their implications for the domestic industry.

In its initial work it would seem that the CTC approach using the yarn-forward method equates to around a rule of 80% content for products to enter as preferential goods for the agreement. This is an unrealistic hurdle to expect to achieve and one that most Australian manufacturers would fail to even come close to. While some of this problem can be addressed by pursuing a different approach to yarn-forward the TFIA would not see that this is a path for the ANZCERTA to proceed down. Rather its members would prefer the administrative costs of adhering to different rules of origin approaches among bi-lateral agreements rather than grappling with the changes required to move to a CTC approach to rules of origin.

A key issue in the discussion of any rules of origin definition is that Australia maintains adequate resources to follow through, check and audit exporter and importer claims. Commercial experience of many TCF companies suggests that, in the face of limited resources for Customs in either member country, the monitoring of preferential goods is more often than not an autonomous exercise. Insufficient resources and backing to identify and penalise exporters and importers who breach these rules allows manipulation of costs and values to occur to the detriment of the domestic economy and the agreement more generally.

In the call for submissions the Commission asked respondents to comment on whether there was a case for industry specific rules of origin under the CER agreement. While the TFIA cannot comment for other Australian manufacturing industries it, as the comments above show, remains happy to work under the existing factory cost system subject to changes in the application of the principles by New Zealand.

The use of trade policies to achieve a particular economic outcome is in many cases a sensible path to move down. In the case of the TCF sectors where a change in the system of determining origin is likely to produce significant adjustment costs it may be more economically sound to exempt the sector from any changes or to provide a longer transition period for companies in that sector. As noted above many countries actively use market access policies as means of industry assistance.

The nature of the TCF sector is such that even these temporary distortions, if significant enough, will produce real economic harm to the industry. The Australian Government is still working with the TCF sector to finalise the nature of assistance to the industry post 2005 but it is known that assistance will remain. The TFIA contends that maintenance of the rules of origin at 50% factory cost will assist the industry in its adjustment phase.

SPARTECA

While having the CER with New Zealand and an FTA with Singapore, Australia is also a member of the South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA)[4]. SPARTECA includes the same definitions for preferential entry of goods as that in the ANZCERTA and the Commission should consider the potential flow on effects of this study for that agreement. Of most importance in the TCF area is Fiji where the majority of its manufactured exports are in the TCF sector.

The impact on SPARTECA nations of having to meet different rules to that of Australia and New Zealand could take two forms. Firstly, changes to the rules of origin under CER could be viewed as providing additional advantage to both Australia and New Zealand. For instance if under CER the 50% rule was reduced to a 35% rule yet remain at 50% under SPARTECA, Fiji and other members would be discriminated against.

Equally, even where a change made to the CER is replicated in SPARTECA the Government must still have consideration for the ability of SPARTECA members to cope with the change. For instance what would be the capability for Fiji to administer and adhere to a NAFTA style change in tariff classification approach?

Council of Textile and Fashion Industries of Australia Limited
17 October 2003

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[0] ABS Labour Force Statistics, 2002
[1] Figures taken from the 'Quarterly Review of Textile, Clothing and Footwear Industries' produced by TFIA Business Services using Australain Bureau of Statistics data sources
[2] Assumed for this exercise to be entering under harmonised code 5112.12 – Woven fabric of combed wool or of combed fine animal hair containing 85% or more by weight of wool or of fine animal hair of a weight greater than $200g/m^2$
[3] p 2 Report to the Congressional Textile Caucus on the Administrations Efforts on Textile Issues, Sept 2002
[4] SPARTECA members – Cook Islands, Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Nauru, Niue, Papua New Guinea, Solomon Islands, Tonga, Tuvalu, Vanuatu and Western Samoa.