

Submission

By

Business|NZ

To

Productivity Commission

On the

ANZCERTA Rules of Origin Study

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**ANZCERTA RULES OF ORIGIN STUDY
SUBMISSION BY BUSINESS NEW ZEALAND
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1. Introduction

- 1.1 Encompassing five regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, Canterbury Manufacturers' Association, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 53-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
- 1.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.
- 1.3 Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.
- 1.4 Exports are critical for economic growth, and for New Zealand there is no overseas market more important than Australia, which takes over 20% of New Zealand merchandise exports. For manufactured products Australia is an even more important market (36% of total manufactured exports).
- 1.5 The Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) is celebrating its 20th anniversary in 2003. Even after 20 years, ANZCERTA is regarded as being one of the most comprehensive, open and simple free trade agreements in existence. It has also been a great success in stimulating trade, with exports to Australia having grown 6-fold and imports from Australia having grown 4-fold since 1983.
- 1.6 Business New Zealand is therefore a strong supporter of ANZCERTA and we agree that much progress has been made over the past 20 years on issues covering the trade of both goods and services. However, we consider that it is now time to take ANZCERTA to another level and that the Australian and New Zealand governments should consider bringing into effect an 'Australia New Zealand Economic Community'¹.

¹ In this respect we endorse the New Zealand Parliament's Foreign Affairs, Defence and Trade Select Committee *Inquiry into New Zealand's Economic and Trade Relationship with Australia*, which in 2002 recommended that an Australia New Zealand Economic Community be established.

1.7 However, before there can be progress towards an Economic Community, existing barriers and costs to trans-Tasman trade must first be addressed. We consider that the Rules of Origin is one such area of ANZCERTA where there are difficulties, so we are pleased that the Productivity Commission is undertaking a review of the Rules of Origin under ANZCERTA.

1.8 Business New Zealand submits that the Rules of Origin are a significant barrier to trade for a number of manufacturers and are becoming increasingly costly and difficult to adhere to. Significant changes are required to address these concerns.

2. Summary of Recommendations

2.1 Business New Zealand recommends that the Rules of Origin under ANZCERTA should be changed from the present requirement of 50% local content to a requirement of substantial transformation based on a change in tariff classification.

2.2 Without prejudice to the primary recommendation above, Business New Zealand would support an immediate reduction in the local content requirement to 40% as a transition to moving to substantial transformation.

3. Manufactured Exports to Australia

3.1 The table below shows data on manufactured exports to Australia by basic manufacturing sector (information provided by Statistics New Zealand).

| Basic Manufacturing Sector | Total Exports \$NZ Million (Year End June 03) | Exports to Australia \$NZ Million (Year End June 03) | Exports to Australia as % of Total Exports |
|--|---|--|--|
| Food Processing | 1,238.85 | 455.92 | 36.8% |
| Beverages and Tobacco | 417.90 | 134.22 | 32.1% |
| Textiles (excluding carpets & rugs) | 207.41 | 136.06 | 65.6% |
| Carpets | 123.99 | 104.79 | 84.5% |
| Clothing & knitting mill products | 180.71 | 139.84 | 77.4% |
| Footwear | 37.58 | 21.14 | 56.3% |
| Leather tanning & fur dressing | 416.73 | 45.64 | 11.0% |
| Sawn timber & wood products | 1,624.00 | 414.32 | 25.5% |
| Paper, paper products & printing | 406.04 | 188.01 | 46.3% |
| Industrial chemicals & petroleum products | 93.19 | 31.70 | 34.0% |
| Synthetic resins | 59.25 | 35.39 | 59.7% |
| Other chemical products | 516.90 | 271.60 | 52.5% |
| Rubber products | 121.43 | 73.83 | 60.8% |
| Plastic products | 336.28 | 216.73 | 64.5% |
| Non-metallic products | 95.63 | 23.00 | 24.1% |
| Iron & steel | 398.06 | 172.15 | 43.2% |
| Non-ferrous metals | 1,203.59 | 324.62 | 27.0% |
| Metal product manufacturing | 381.41 | 173.24 | 45.4% |
| Transport equipment | 463.88 | 145.82 | 31.4% |
| Electronic equipment | 626.43 | 122.09 | 19.5% |
| Household appliances | 400.30 | 270.34 | 67.5% |
| Electrical equipment | 457.87 | 144.53 | 31.6% |
| Agricultural equipment | 128.35 | 50.63 | 39.4% |
| Industrial machinery & other equipment | 564.06 | 249.53 | 44.2% |
| Furniture | 91.18 | 73.38 | 80.5% |
| Other manufacturing (inc confidential items) | 1,356.39 | 329.61 | 24.3% |
| Total Basic Manufacturing Sector | 11,947.39 | 4,348.14 | 36.4% |

3.2 The table shows that Australia takes 36.4% of all New Zealand manufactured exports. For some sectors Australia is particularly important, especially carpets (84.5%), furniture (80.5%), clothing and knitting mill products (77.4%), household appliances (67.5%), textiles excluding carpets and rugs (65.6%), plastic products (64.5%), and rubber products (60.8%). A number of these sectors happen to be highly sensitive to the Rules of Origin.

4. Rules of Origin - Background

4.1 Rules of Origin require goods exported to a free trade agreement partner to have a certain percentage of 'local content'. They are designed to prevent third-country exporters abusing a free trade agreement they are not a party to by re-exporting through a partner to a free trade agreement, so bypassing tariffs and other trade barriers in place for third-country trade.

4.2 Rules of Origin are common practice internationally and are seen to be critical for preserving the integrity of the agreement and for ongoing political and economic support. The experience of the stalled negotiations on a proposed Hong Kong – New Zealand Closer Economic Partnership indicates the importance of a robust and credible Rules of Origin regime to an acceptable agreement.

4.3 In the context of ANZCERTA, preferential rates of duty (tariffs have been set at zero since 1990) are extended by Australia and New Zealand to each other's produce or manufacture in accordance with the Rules of Origin provisions of ANZCERTA. Each country implements the Rules through their own relevant domestic legislation².

4.4 Under ANZCERTA Rules of Origin goods are divided into three categories:

1. Goods wholly the produce of the country (un-manufactured raw materials).
2. Goods wholly manufactured in the country from one or more of the following:
 - (a) Un-manufactured 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.
3. Goods partly manufactured in the country.

4.5 While there are a number of provisions around Category 2 goods (particularly with respect to the use of imported materials as 'determined manufactured raw materials'), most of the issues around Rules of Origin fall under Category 3 goods.

4.6 With regard to Category 3 goods, the criteria governing preference entitlement under the Rules of Origin is:

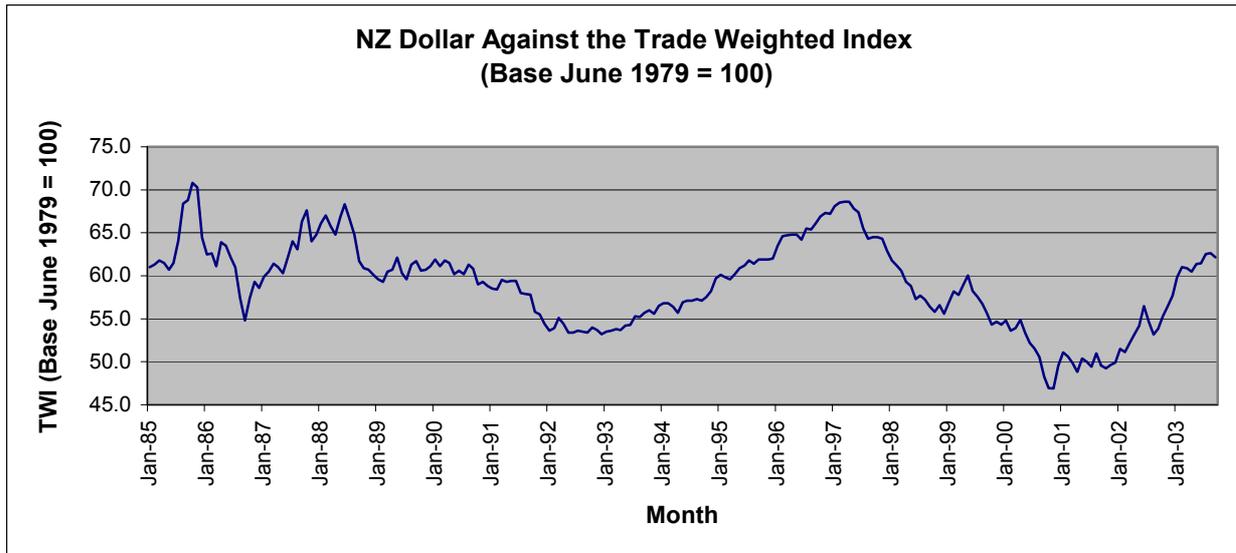
² In New Zealand's case, the Customs and Excise Act 1996 (sections 65-67) and the Customs and Excise Regulations 1996 (regulations 32-39).

- (a) The last process of manufacture must be performed in either Australia or New Zealand; and
 - (b) Not less than 50% of the factory cost must be represented by the qualifying expenditure of the manufacturer.
- 4.7 'Manufacturing' is regarded as meaning that what is made is a different thing from that out of which it is made. Restoration and other minimal and operational processes are *not* regarded as constituting manufacture. Furthermore, the 50% rule is subject to a number of criteria around what is and is not qualifying expenditure.
- 4.8 The Rules of Origin are complex and manufacturers must closely monitor their processes and costs to ensure that they stay within the criteria.

5. Problems with Current Rules of Origin

- 5.1 With Australia taking 36% of New Zealand manufactured exports, the Rules of Origin under ANZCERTA are clearly a high priority for many New Zealand manufacturers. Business New Zealand considers that the Rules of Origin need a fundamental review. In particular, the 50% local content requirement is becoming increasingly onerous for manufacturers who export to Australia.
- 5.2 When ANZCERTA was agreed in 1983 a 50% local content requirement was probably appropriate considering the international trading environment of the time. However, the past 20 years have seen major changes, including removal of protection of domestic industries and the forces of globalisation. Manufacturers have to increasingly source inputs of production (particularly raw materials and intermediate products) at the lowest cost in order to remain cost competitive – for New Zealand (and Australia) this increasingly means importing. As well as cost advantages, importing can also provide a greater variety of raw materials and intermediate goods, so providing manufacturers with greater opportunities to differentiate their completed product.
- 5.3 As with all regulatory interventions that are designed to prevent abuse of regimes that provide a form of preferential treatment or access, compliance requirements under the Rules of Origin are onerous and require vigilance and the production of considerable paperwork. This means that there are high compliance costs associated with developing and maintaining systems to determine actual costs on the date of shipment and for overall day-to-day monitoring.
- 5.4 More significantly though, the compliance requirements mean that if a manufacturer cannot provide complete documentation then tariff-free entry is refused (even if the product has in fact been produced domestically). Failure to comply can potentially be extremely costly and in the case of garments companies often have to resort to other ways of making the product compliant, such as by including hangers, belts etc.

- 5.5 Business New Zealand's consultation of members found that the Rules of Origin impact upon exporters across many manufacturing sectors. The textile, clothing, and footwear (TCF) sectors had the most significant concerns about the Rules of Origin, but we were also made aware of examples in appliance manufacturing and plastics manufacturing. The TCF sector's particularly high level of concern is not surprising considering that Australia is the major export destination for their products. It is also the sector that has most to lose from breaching the Rules of Origin (due to Australian TCF tariffs being as high as 25%).
- 5.6 The complexity of the Rules of Origin requirements, particularly around the local content requirement, causes considerable compliance costs for many manufacturers. While some of the larger businesses that have had a long track record in exporting have the experience and capacity to cope with the Rules of Origin, there are a growing number of smaller niche manufacturers, particularly in the fashion industry, who have only recently begun exporting over the past few years. Many of them are finding the Rules of Origin to be particularly complicated and costly to comply with.
- 5.7 The 50% local content requirement prevents some companies from offering products made from higher priced fabrics, the great majority of which are sourced offshore and which have a significant negative impact on the local content. Fabrics have become a larger proportion of the total cost of garments over time, and with increased efficiencies and more sophisticated fabrics it has become more difficult for companies to remain within the 50% local content requirement. As a result, there are exporters that either do not offer some of their product line to the Australian market, have their products finished in Australia, or sometimes even resort to using inferior components.
- 5.8 Business New Zealand also considers that the 50% local content requirement perversely discriminates against those manufacturers that want to make efficiency improvements in their production as doing so would make it even harder to stay within the limit.
- 5.9 Exchange rate movements impacting upon the cost of imported materials can also have significant impacts on the proportion of local content in a finished product. When CER (and the Rules of Origin) was agreed in 1983 the New Zealand dollar was fixed against a basket of currencies, although it was adjusted whenever the exchange rate appeared to move out of line with economic conditions. The New Zealand dollar was floated in 1985 and since that time currency volatility has been a fact of life that exporters and importers have had to take careful consideration of.
- 5.10 There have been large fluctuations in the value of the New Zealand dollar over the past two decades (as has also been the case for all currencies operating under a floating regime, including Australia's), as is shown in the chart on the following page.



- 5.11 When the New Zealand dollar appreciates (as has generally been the case over the past two years), imports become cheaper, so increasing the proportion of costs that is 'domestic' and making it easier for manufacturers to meet the local content requirement. However, when the dollar depreciates, imports become dearer, so decreasing the proportion of costs that are domestic and making it harder for manufacturers to meet the local content requirement.
- 5.12 While the impact of large exchange rate fluctuations are obvious, for many manufacturers on the margin of the 50% limit even a small depreciation in the dollar can have a major impact. While currency hedging can help mitigate the risk, many small and medium sized exporters (of which there are many in the sectors most sensitive to the Rules of Origin) find hedging to be unsuitable for what are often small amounts or simply do not have the capability or sophistication to engage in the practice.
- 5.13 Exchange rate volatility can be especially difficult for the TCF sector, particularly when garment manufacturers decide to use a new fabric in their range. The garment industry generally sells on 'indent' (that is, selling their product a season or more in advance), so have to make a decision at that time as to whether or not to pay duty. By the time the fabric arrives for manufacture exchange rate fluctuations can often mean that the manufacturer may not have priced the garment correctly. Selling under indent can be a significant problem as the manufacturer cannot go back to the buyer and renegotiate a new price.
- 5.14 The impact of exchange rate volatility is without doubt one of the main reasons why many New Zealand manufacturers advocate abandoning the local content percentage altogether and move to substantial transformation based on a change in tariff classification.

6. Reform of the Rules of Origin – Move to Substantial Transformation

- 6.1 Having set out the problems with the existing Rules of Origin regime, Business New Zealand appreciates the opportunity to suggest options for reform.

- 6.2 In preparing this submission, Business New Zealand consulted its five regional associations and those members of its affiliated industries group that represent manufacturers. We also asked the views of a selection of companies in the textile, clothing, and footwear sectors.
- 6.3 The strong preference of those we consulted was for a move to substantial transformation based on a change in tariff classification. The rationale for proposing such a change was that substantial transformation would create an easier and more predictable basis for determining qualification for duty free access.
- 6.4 Substantial transformation would address many of the compliance aspects of having to assess the cost components and what does and does not qualify as allowable factory expenditure. But more significantly, it would remove the uncertainty and risks around exchange rate volatility discussed above.
- 6.5 Substantial transformation has been adopted for the rules of origin in a number of the more recent free trade agreements, including the North America Free Trade Agreement (NAFTA), which will presumably form the basis for the American position on rules of origin in negotiations for a free trade agreement with Australia. The Uruguay GATT Round agreed in 1994 agreed to work towards developing rules on how substantial transformation based on change in tariff classification should work for rules of origin. Regrettably, this work has not been advanced.
- 6.6 Business New Zealand accepts that there can be problems with using a method of substantial transformation. New Zealand manufacturers, for example, would not support complicated additional qualifications such as those around 'secondary transformation' included in the NAFTA agreements. Some of those concerned about moving to substantial transformation worry about adjustment costs in moving to a new system. Adjustment costs are inevitable with any change. If change were put off because of fears about possible costs then there would never be any change. The appropriate approach to take is that of economic efficiency, where the benefits of change as well as the costs are objectively assessed by analysing the allocative, productive and dynamic efficiency considerations.
- 6.7 One of the major concerns of one manufacturer was that while advocating substantial transformation was all very well, the likely time needed to first convince Australia of its desirability, carry out negotiations and (if successful) implement a new system would mean that the opportunity to make other changes quickly could be lost. This concern could be addressed by making immediate adjustments to the existing rules of origin (perhaps by reducing the local content rule to 40%) as a way of transitioning to a more ambitious goal of substantial transformation.
- 6.8 Another argument that we are aware of is that with both countries' tariff levels now scheduled to fall over the coming years the benefits of adhering to rules of origin will also fall. At present with Australian tariffs being as high as 25% and New Zealand tariffs being as high as 19% there is certainly considerable

value in adhering to rules of origin. The Australian top tariff rate is scheduled to fall shortly to 17% (with more falls likely) and New Zealand has recently committed to ending its tariff freeze in 2005 and reducing its few remaining tariffs to no more than 10% by 2009. Therefore, within several years, tariffs for many goods are likely to be very low (if non-existent) and it has been argued that radically changing the rules of origin would be pointless and would impose higher costs than there would be benefits.

- 6.9 There is probably more weight to this argument, but these future tariff reductions are by no means set in concrete. It is unlikely, but future governments (in both countries) could decide to halt or even reverse tariff reductions. In any event, tariffs as low as 10% could still make adherence to a rules of origin regime worthwhile and change to substantial transformation could still have a positive benefit/cost ratio.
- 6.10 Overall, Business New Zealand considers that any problems with substantial transformation should not be insurmountable. It should certainly not be beyond the ability or the will of both Australia and New Zealand to mitigate potential problems by designing a simple and clean regime in good time.
- 6.11 *Recommendation: Business New Zealand recommends that the Rules of Origin under ANZCERTA should be changed from the present requirement of 50% local content to a requirement of substantial transformation based on a change in tariff classification.*

7. Second Best Approach – Reducing Local Content Level to 40%

- 7.1 Business New Zealand is aware that there have been discussions over a long period of time with respect to the possibility of lowering the local content level from 50% to 40%. 40% local content would be consistent with the rules of origin under New Zealand's Closer Economic Partnership with Singapore. Moving to 40% for the ANZCERTA rules of origin would certainly be a step in the right direction, but Business New Zealand's view is that such a change does not go far enough – the problems with adhering to the compliance and exchange rate issues discussed above will remain – the only difference being that the percentage is set at a lower rate. Business New Zealand's preference is ultimately for a move to substantial transformation, as discussed above.
- 7.2 *Recommendation: Without prejudice to the primary recommendation in paragraph 6.11 above, Business New Zealand would support an immediate reduction in the local content requirement to 40% as a transition to moving to substantial transformation.*

8. Conclusion

- 8.1 The Rules of Origin under ANZCERTA impose an impediment to efficient production and significant compliance and other costs for a number of export manufacturers, particularly in the textile, clothing, and footwear sectors – as such a strong argument can be made that they run counter to the spirit of ANZCERTA and its evolution and development into an ANZEC.

- 8.2 Business New Zealand considers that it is timely that the Rules of Origin are reviewed from a first principles perspective. We consider that the existing 50% local content requirement is particularly onerous for those trying to make efficiency gains and those that are vulnerable to exchange rate volatility.
- 8.3 Business New Zealand therefore submits that there should be a change to substantial transformation based on change in tariff classification. While Business New Zealand would support an immediate reduction in the local content requirement to 40% we would consider it to be an interim measure as a transition to the more ambitious goal of substantial transformation.