

Regulation Impact Statement

Australia – New Zealand Closer Economic Relations Trade Agreement: Changes to Article 3 (Rules of Origin Provisions)

I. Background

The Australia – New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) is now 22 years old. It was signed by the Governments of Australia and New Zealand on 28 March 1983. The objectives of the ANZCERTA are to:

- (a) strengthen the broader relationship between Australia and New Zealand;
- (b) develop closer economic relations between the Member States through a mutually beneficial expansion of free trade between New Zealand and Australia;
- (c) eliminate barriers to trade between Australia and New Zealand in a gradual and progressive manner under an agreed timetable and with a minimum of disruption; and
- (d) develop trade between New Zealand and Australia under conditions of fair competition.

The Agreement's main method for achieving these goals, at least initially, was through the elimination of tariffs on trade between Australia and New Zealand. Access to the preferential tariff rate is only available to goods that have been substantially transformed in either or both countries. Substantial transformation is defined in the ANZCERTA's Rules of Origin (ROO), and can be summarised as follows:

- the last process in the manufacture of the good must take place in Australia or New Zealand; and
- at least 50 per cent of the cost of producing the good is incurred in Australia or New Zealand.

Since 1990, all goods that meet the ANZCERTA ROO can be traded duty-free between Australia and New Zealand.

Over the last 22 years, the context of the ANZCERTA has altered considerably as both the Australian and New Zealand economies have changed and grown. Changes to industry have led some businesses, particularly in New Zealand, to claim that the ANZCERTA ROO act as a barrier to growth and trade.

This became more evident in 2002 when Australian apparel manufacturers that outsource their last process of manufacture (for stitching, attachment of labels, zippers, buttons, etc) were failing to meet ANZCERTA's 50 per cent local content threshold as implemented in New Zealand, even though the underlying Australian local content may have exceeded 50 per cent. Such export shipments were subjected to 19 per cent tariff duties.

New Zealand rectified the problem through changes to the *New Zealand Customs and Excise Regulations 1996* on the basis of a formal Arrangement between the Australian and New Zealand Governments, signed by the Minister for Trade, the Hon. Mark

Vaile MP, on 23 December 2003. The Arrangement replaced, in its entirety, a previous Joint Understanding on Article 3 (Rules of Origin) as constituted by an Exchange of Letters of 6 October 1992. The Arrangement extends the concept of a 'Principal Manufacturer' to ANZCERTA – as contained in the Singapore Australia Free Trade Agreement (SAFTA) – so as to ensure that all genuine local content is counted towards the ROO and that there is equity of treatment as between integrated manufacturers and those that outsource production.

New Zealand's new regulations entered into force on 15 January 2004. Under the Arrangement, Australia was to make legislative changes to bring Australian legislation (*Customs Act 1901*) into line with the New Zealand regulations by mid-2004. This would achieve equal treatment of outsourced manufacture on both sides of the Tasman. Australia has deferred introducing its legislative amendments pending the finalisation of the current negotiations on ANZCERTA ROO.

New Zealand only agreed to correct the 'outsourcing' anomaly as part of a broader package of ROO reforms. In response to these and other concerns, Mr Vaile, and the then New Zealand Minister for Trade Negotiations, the Hon. Jim Sutton, agreed at the CER Ministerial Forum held in Sydney on 28 August 2003 that officials from Australia and New Zealand should examine the ANZCERTA ROO with a view to considering whether other improvements which would benefit businesses on both sides of the Tasman should be made. On 28 August 2003, the Parliamentary Secretary to the Treasurer, Senator the Hon. Ian Campbell, also announced a study by the Productivity Commission (PC) into economic and administrative problems with the ANZCERTA ROO.

In line with the directions provided by Ministers, Australian and New Zealand officials developed a proposal that would allow imported 'intermediate inputs' to be disregarded from the calculation of the total cost of the finished good for the purpose of determining local content under the ANZCERTA. In response to significant opposition to the 'intermediate inputs' proposal, particularly from the textile, clothing and footwear sector, it was decided that a 33 per cent cap (of the total ex-factory cost of the finished good) would apply to the use of the new provision to ensure there was no abuse of the new arrangements.

The Australian Government considered the proposal, and associated amendments to the ROO Provisions of ANZCERTA (Article 3), on 16 February 2004. Ministers agreed to amend Article 3 to provide scope for technical changes to elaborate and improve ANZCERTA ROO but deferred a decision on the 'intermediate inputs' proposal pending the report of the PC study of the ROO.

In its final report, released on 11 June 2004, the PC concluded that ANZCERTA ROO were outdated and acted as a constraint on further trade. The current ROO had not kept pace with changes in technology and the organisation of production, which had the effect of reducing efficiency and imposing economic costs on both sides of the Tasman. The PC advocated liberalising the ROO by applying a waiver to provide duty-free entry for CER goods manufactured in Australia and New Zealand which face trans-Tasman tariff differences of five percentage points or less. It also recommended a number of minor amendments to improve operational efficiency.

Following the PC report, Australian officials consulted with Australian industry on the Commission's recommendations, which industry generally opposed. There was, however, some agreement that some problems identified by the PC were constraining trade.

In light of the PC report and the level of opposition to the ‘intermediate inputs’ proposal, Australian and New Zealand officials again discussed options for updating ANZCERTA ROO. In particular, officials considered a Change of Tariff Classification (CTC) approach to determine origin and reduction in the RVC for goods with inputs subject to most-favoured nation (MFN) tariffs of 5 per cent or less in Australia or 7.5 per cent or less in New Zealand. Under a CTC approach, imports are required to undergo a specified change in tariff classification. Substantial transformation is said to have occurred if a good is classified to a different tariff classification than that of its component materials after production. The CTC method is used in Australia’s FTAs with the United States (AUSFTA) and Thailand (TAFTA). A secondary requirement, such as a regional value content (RVC) threshold being met, may be included where substantial transformation may not result in a change of tariff classification or where it is agreed that a change of tariff classification is insufficient to confer origin.

In July 2004, CER Ministers agreed that it might be possible to achieve the improvements identified by the PC through a CTC model, without the uncertainties associated with adopting a new and untested approach like the PC’s waiver proposal. A CTC model could simplify the administration of ROO, improve transparency and reduce compliance costs, and would reflect an increasing global trend towards CTC ROO in bilateral trade agreements, benefiting export-oriented industries in both countries.

On 31 August 2004, the Minister for Trade, the Hon. Mark Vaile MP, wrote to the Prime Minister seeking approval to enter negotiations with New Zealand to adopt a CTC approach. On 4 November 2004, the Acting Prime Minister, the Hon. Peter Costello MP, responded agreeing to enter negotiations, subject to appropriate consultation with Australian industry and that the arrangements should be settled in consultation with the Prime Minister and relevant Ministers.

At their annual CER Ministerial meeting, on 11 December 2004, Australian and New Zealand Trade, Agriculture and Industry Ministers’ announced that agreement had been reached on adopting a CTC approach to ANZCERTA ROO, subject to final agreement on sensitive sectors. Ministers also committed to negotiate a CTC model that would be no-less liberal than the current arrangements and that would liberalise all tariff lines over time.

Australian Government officials consulted extensively with Australian industry associations and most industry groups supported the proposal (see VII: Consultation for details). Several of these industry groups questioned the need for change from the existing arrangements given the success of ANZCERTA but eventually supported the proposal, on the proviso that their concerns were addressed.

On 28 November, Australian Ministers agreed on a CTC-based schedule that included secondary regional value content (RVC) requirements on a limited number of tariff lines, including an RVC of 40 per cent on a build-down basis for vehicles and vehicle parts and an RVC of 50 per cent (reducing to 45 per cent from 2010) for men’s suits and structured apparel (e.g. trousers, blazers and overcoats). Cognisant of the commitment to ensure that a CTC approach should at least be no-less liberal than the current arrangements, Ministers also agreed to a grandfathering clause which would allow exporters to claim origin under the pre-existing ex-factory/principle place of manufacture approach for a five year period following the adoption of the CTC approach if, for some reason, they were no longer able to claim origin under the CTC

ROO, and that a review of the revised ROO be completed within three years after adoption of the CTC approach.

Prime Minister Howard wrote to Prime Minister Clark on 12 December 2005 confirming Australia's position on the package of rules. New Zealand Ministers for Economic Development (Mallard) and Trade Negotiations (Sutton) responded on 23 December 2005 confirming their agreement to the package. Australian and New Zealand Ministers simultaneously announced the Governments' agreement to adopt the CTC on 3 February 2006, with an anticipated implementation date of 1 January 2007.

II. The Problem

As noted above, the past 22 years have seen considerable changes in the structure and make-up of the Australian and New Zealand economies. Progressive policies of tariff reduction and structural reform have led to changes in the range and types of products manufactured in each country. The current ex-factory/last place of manufacture approach to ANZCERTA ROO is no longer appropriate for most industry sectors, as they can be time-consuming and administratively burdensome, especially when having to take account of shifts in exchange rates and fluctuations in the international prices of materials. The PC study of ANZCERTA ROO identified a number of problems with the current ROO (see V: Impact Analysis, Option 1, Costs).

The requirement that goods meet the 'last place of manufacture' test to claim origin also results in apparel manufacturers that outsource their last process of manufacture (including for stitching, attachment of labels, zippers, buttons) failing to meet the ANZCERTA's 50 per cent local content threshold, even though the underlying local content may have exceeded 50 per cent. Changing the 'last place of manufacture' to 'principal manufacturer' resolves this problem. New Zealand has passed legislative amendments to do so. Australia is yet to finalise its legislative requirements and proposes to do so as part of this package of broader reforms.

Total trans-Tasman trade was valued at \$14.5 billion in 2004-05, and approximately 2 per cent of this trade is still subject to tariffs. Therefore, the upper limit of current trans-Tasman trade that could potentially benefit under a proposal to liberalise the ANZCERTA ROO would be approximately \$290 million (i.e. 2 per cent of \$14.5 billion).

The Australian Government does not have statistics on preference use by Australian exporters. The PC Study notes that around one-third of Australian exports to New Zealand are in goods which would be subject to MFN tariffs if they did not meet the ANZCERTA ROO. The PC also notes that, in 2001, Australian exports into New Zealand liable for duty included chemicals and plastics, paper and paperboard, fabrics, ceramic products, glass and glassware, metals and electrical machinery and equipment. The average tariff rate faced by these goods was 5 per cent.

New Zealand's exports to Australia liable for duty are in similar products, including chemicals and plastics, paper and paperboard, fabrics, clothing, jewellery, metals, machinery, electrical machinery and equipment and motor vehicles and parts. The MFN tariffs in these areas were mainly 5 per cent, with tariffs of 10 per cent for fabrics and motor vehicles and parts and 17.5 per cent for clothing.

It is difficult, however, to estimate how much trade is forgone by producers who do not export because the tariff differential is significant enough to make their product uncompetitive but they consider the process of seeking preferential tariff treatment too complex. The generally low level of tariffs in Australia and New Zealand therefore

acts as an impediment in this case – the tariff may be enough to make products uncompetitive in the other market and the cost of seeking preference outweighs the benefits.

III. Objectives of the Proposed Changes

The Government considers that the ROO should not act to constrain the development of innovative and efficient business practices in Australia and New Zealand. Rather, ANZCERTA ROO should recognise changing economic drivers as both economies seek to become more internationally competitive and facilitate trans-Tasman trade in goods manufactured in the Free Trade Area.

The objectives of amending ANZCERTA are to:

- lower compliance costs for businesses attempting to prove their conformity with the ROO requirements to attain preferential market access;
- reduce the incentives for inefficient production processes by business in order to meet the ROO requirements;
- improve consistency of treatment and interpretation of the ROO by Customs agencies in Australia and New Zealand;
- improve consistency between Australia’s free trade agreements.

IV. Options

There are several options available for action.

Option 1: No change (status quo)

This option simply maintains the status quo. This would have no impact on tariff revenue.

Option 2: Adopt PC study recommendations

In its report on the ANZCERTA ROO the Productivity Commission made two recommendations about the form of the ROO:

- waive the 50 per cent factory cost requirement where Australian and New Zealand tariffs differ by less than 5 per cent; and
- lower the 50 per cent threshold on the remaining goods in the short term, and eliminate the requirement completely in the longer term.

The PC’s recommendations are intended to increase market access under ANZCERTA by expanding the range of goods that meet the ROO. Thus both recommendations would lead to some loss of tariff revenue for the Government, the extent of which is difficult to calculate.

Option 3: Adopt CTC ROO (preferred approach)

The CTC approach is a product-specific approach to rules of origin where non-originating inputs must undergo a specified change of tariff classification (based on the World Customs Organisation’s Harmonized System of Tariff Codes – the HS Code) in producing the final good. The method by which this is done is usually not specified although it may be implicit in the required change of classification. In some cases processing is specified such as where a well-accepted transformation takes place (e.g. chemical reactions) or a standard change of tariff classification would allow minor processing to confer origin.

V. Impact Analysis

Approximately 2 per cent of Australia's exports to New Zealand do not enter duty-free (i.e. enter at free rates of duty or under the tariff preference) and face non-preferential tariff rates ranging from 5 per cent to 19 per cent. The major Australian exports affected include plastics and chemicals, paper and paper products, fabrics, ceramic products, glass and glassware, metals and electrical machinery and equipment. In 2004-05, Australian exports to New Zealand were valued at approximately \$9.2 billion. Therefore the upper limit of current trade potentially affected by this proposal would be approximately \$183 million (i.e. 2 per cent of \$9.2 billion).

Approximately 2 per cent of imports from New Zealand fail to enter Australia duty-free. The value of imports from New Zealand that could potentially benefit from the proposed change to the ROO is around \$106 million at most.

Quantitative data is not available on the level of trans-Tasman trade which would benefit from the proposed changes as it is unlikely that all trans-Tasman trade currently subject to duty would enter duty-free under the proposal. Nor is it possible to estimate how much trade is foregone by producers who do not export because the tariff differential is significant enough to make their product uncompetitive in the other market but the process of seeking preferential tariff treatment is considered too complex or too administratively burdensome.

A detailed comparison of the compliance costs for each option has not been prepared as these will vary considerably from industry to industry and company to company. In general, however, the compliance costs for the CTC method are estimated to be far less expensive as the special calculations required to confirm that a product meets the ROO under the ex-factory cost or related approaches are not required under CTC.

Option 1: No change (status quo)

Benefits

On the surface, the current ANZCERTA ROO do not serve as a major impediment to trade between Australia and New Zealand. While around 47 per cent of two-way merchandise trade between Australia and New Zealand is in tariff lines which are subject to tariffs and would be subject to duty if the merchandise did not satisfy origin requirements, 98 per cent of these goods satisfy the ANZCERTA ROO requirements for duty-free access. This high level of preference utilisation and generally low tariffs indicate that the scope for further improvements in preferential trade between Australia and New Zealand is limited.

The current ANZCERTA ROO have been in place for over 20 years. Industry is comfortable with their operation and has not made any strong calls for the ROO to be changed. Manufacturers on both sides of the Tasman have adopted business practices to take advantage of the ROO, and in some cases this has meant a carefully calibrated production process to ensure they meet its requirements. The Government was informed that some companies have computer software to allow them to monitor, and thereby adjust, their costs according to changing market conditions in order to meet the ROO.

Retaining the existing arrangements would also have no impact on Government revenue.

Costs

However, Australian industry has expressed a desire for a consistent approach to ROO in Australia's free trade agreements (FTAs) in order to minimise problems in both understanding and applying them. This has been supported by comments from industry in subsequent consultations for FTAs other than ANZCERTA.

The PC study also identified a number of problems with the current ROO which, if resolved, could provide some scope for increased trade. These included the:

- potential for inconsistent treatment and/or interpretation of the ROO by Customs agencies in Australia and New Zealand;
- restrictiveness of the 'last process of manufacture' test, including problems with the treatment of outsourcing and commission work;
- disincentive to improve efficiency/reduce costs;
- disincentive to use higher value imported materials;
- incentive to incur local costs to achieve the 50 per cent threshold;
- treatment of specific material and overhead expenses in the factory cost calculations; and
- level of compliance and adequacy of enforcement measures.

In addition, the current ROO can also be time-consuming and administratively burdensome and industry must make special calculations to confirm a product meets the ROO. As noted by the PC, the factory cost basis for the ROO has led to a strict delineation of 'factory costs': what may be included and how they are apportioned to production of the goods. Although businesses would have information on these costs, the calculation of qualifying and total expenditure on a good's production are not the same as the cost accounting approach to these goods. Small inconsistencies in the treatment of these costs by either Government can also lead to significant differences in whether a good qualifies or not. The PC noted the impact of different treatment by Australia and New Zealand of goods provided at less than normal market value (including free of charge) and materials of mixed origin.

It is also possible for the ex-factory approach to produce "unfair" outcomes in that the same good produced according to the same process (and using the same imported materials) may qualify as originating in one party to an agreement but not in another party because of differences in the relative costs of production in the two countries.

Shifts in exchange rates and fluctuations in international prices of materials can significantly affect an exporter's final cost structure, creating uncertainty as to whether the ROO will be met. For example, the Australian exchange rate has appreciated by more than 40 per cent against the US dollar since the beginning of 2002 – which affects the capacity for exported goods to meet the single costs threshold ratio used in the value added approach to ROO. Another example is the dramatic impact that fluctuating world oil prices has on the costs and price ratios for products with high hydrocarbon content. These factors can mean that a good that qualifies under the value added approach at a particular time may not qualify in the future even though the same production process is used.

Option 2: Adopt PC study recommendations

In its study, the PC made two recommendations about the form of the ROO:

- waive the 50 per cent factory cost requirement where Australian and New Zealand tariffs differ by less than 5 per cent; and
- lower the 50 per cent threshold on the remaining goods in the short term, and eliminate the requirement completely in the longer term.

As part of the recommendations the PC also proposed expanding the ‘last place of manufacture’ concept used in the ROO to a ‘principal manufacturer’ concept and adopting a standard definition of manufacture from the Singapore Australia Free Trade Agreement (SAFTA). The inclusion of the ‘principal manufacturer’ concept has already been agreed by the Australian and New Zealand Governments.

The PC’s recommendations were intended to increase market access under ANZCERTA by expanding the range of goods that meet the ROO. To the extent that they make it easier to claim preference on goods which currently fail to meet the ROO and pay the MFN tariff there will be an impact on Government revenue. This would affect a maximum of around \$2.9 million of duty collected by the Government, based on 2004-05 figures. Any trade created by the changes will also increase revenue foregone however, to the extent that this trade is not currently taking place from any source, it should not impact directly on the Budget. The PC regime also had the potential to allow transshipment or trade diversion through Australia and New Zealand with very low levels of transformation within the parties.

I. Waiver of 50 per cent factory cost requirement

Benefits

By removing the ex-factory cost test, the waiver would resolve most of the problems identified by the PC with the current ROO arrangements. The PC noted that the waiver would:

- significantly reduce compliance and administration costs for industry and the Government. Detailed costings and the attendant paperwork would no longer be needed to claim and verify the origin of imports;
- remove impediments to efficient sourcing of inputs and technology, increasing productivity, business efficiency and market choice; and
- increase trade opportunities and market access across the Tasman.

The PC’s argument in favour of the waiver rests, in part, on the assumption that ROO are not important when the most-favoured nation (MFN) tariffs in Australia and New Zealand are either identical or nearly identical. In this situation, the PC argued that there is no incentive to transship goods due to transport costs and the need to satisfy the manufacture criteria. This is due to the (approximately) equal protection afforded to each market, ignoring the presence of duty drawback under ANZCERTA. Duty drawback means that New Zealand exporters do not face a tariff on the imported components of their goods that are exported to Australia (likewise for goods exported to New Zealand), providing a cost advantage.

In the study, the PC noted that some submissions argued that the waiver would cut across established industry adjustment plans. By making it easier to gain origin, the proposal creates additional competition for industries going through adjustment, beyond what was expected during the discussions for the future assistance packages.

Waiving the threshold also places a greater burden on the last process of manufacture requirement. The PC proposed adopting a standard definition of manufacture to strengthen this element of the ROO. However, the standard definition did not provide

clear delineation of what constitutes manufacture under the ROO. Hence litigation could still have occurred and the change would have led to a transitional intensification of legal disputes.

Costs

In the consultations by the Government with Australian industry about possible changes to the ROO, industry groups expressed strong reservations about the waiver proposal in the PC report. Industry saw the waiver as undermining the operation of the ANZCERTA ROO, particularly in the presence of duty drawback which allowed New Zealand industry to escape tariffs on their inputs for goods exported to Australia. Industry argued that this would provide an unfair advantage to New Zealand industry and create additional competitive pressures in the domestic market, particularly for the textile, clothing and footwear (TCF) sector.

II. Reduce and eliminate the 50 per cent factory cost requirement

The benefits and costs of (eventual) elimination of the ex-factory cost threshold are the same as for the waiver, outlined above. The key difference is that elimination of the threshold would ensure that all goods are covered while the waiver would leave some goods outside the coverage of the new arrangements, at least until the tariff arrangements had changed sufficiently.

As for the waiver, eliminating the threshold places a greater burden on the last process of manufacture requirement.

Benefits

The Productivity Commission noted that reducing (and eventually eliminating) the local content threshold would provide the following advantages:

- allow greater choice in the selection of, and origin of, inputs;
- lower the barriers to trade posed by the ROO;
- allow a greater margin for future technological and organisational changes, productivity gains and currency fluctuations; and
- be simple to implement and involve negligible transition costs.

Costs

The PC identified the following disadvantages from reductions in the threshold:

- it would not address the compliance and administration costs associated with the factory cost methodology; and
- it does not provide a long term solution to threshold-related problems.

The PC noted a number of submissions that commented that reducing the threshold merely moves the problems associated with the threshold to a new level. Correspondingly, lowering the threshold to, say, 40 per cent ex-factory cost, creates new marginal exporters at that level or allows industry to adjust their production to allow them to meet the new threshold.

The Government's consultations following the PC report revealed strong opposition to reducing or removing the 50 per cent threshold among industry. Industry views the current ROO arrangements as a whole, and is opposed to weakening any element of it. Some industries indicated that while they may have been more disposed to a lower

threshold, due to the history of the single threshold in ANZCERTA, they did not wish to move “ahead of the pack”.

Option 3: Adopt CTC ROO (preferred approach)

Benefits

The advantages of CTC ROO are that it:

- is objective – there is a single, clear rule for each tariff line, providing certainty as to what constitutes ‘substantial transformation’, regardless of the method used to produce the transformation;
- dispenses with the regional value content threshold for the vast majority of products;
- improves efficiency by allowing greater use of inputs not produced in Australia or New Zealand without an adverse impact on the ability to claim origin;
- is consistent with Australia’s more recent free trade agreements;
- does not apply ROO on a “one-size fits-all” approach; and
- reduces compliance and administrative costs, removing issues relating to exchange rates, fluctuating world commodity prices or the need to enter into debates over allowable and non-allowable costs, etc.

The HS Code is an internationally agreed system for classifying goods, used by most Customs agencies worldwide, including Australia and New Zealand. The HS Code is used to classify both imports and exports by the Australian and New Zealand Customs Services. The system is a hierarchical, numerical classification system of headings and subheadings based on six digits that uniquely identify all traded goods and commodities. Australia and New Zealand provide further disaggregation by the use of extra digits although these are not commonly used in CTC ROO since they are not internationally agreed.

The HS Code classifies goods according to specificity of description (i.e. where they are best described) and the essential character of the goods. The method for classifying goods is contained in the Commonwealth *Customs Act 1995* and the Australian Customs Service provides an advisory service on the classification of goods.

As noted above, the ROO are transparent in terms of what transformations are allowed. This enables exporters to clearly identify if they have met the ROO based on their inputs and final product without the uncertainty of whether what they have done constitutes ‘manufacture’.

During Government consultations following the PC report, and for subsequent FTAs, industry has expressed strong support for CTC ROO. The consultations for the Thai and United States Free Trade Agreements have familiarised industry associations and individual businesses with this approach. Industry represented agreed that consistency in approach across FTAs reduces the compliance burden of any system of ROOs.

The CTC ROO also enables the Government to address the concerns of particular industries without impacting on other sectors. The product-specific nature of the CTC ROO encourages industry to think in terms of particular products rather than the ROO as a whole. This has fostered greater liberalisation than might otherwise be possible.

The majority of the CTC ROO therefore have no regional value content requirement. The transformation described by the tariff change is clear and sufficient to ensure 'substantial transformation'. Given the economic integration and close trading relationship between Australia and New Zealand, the ANZCERTA CTC ROO are generally more liberal than those with the United States and Thailand.

The CTC proposal will not increase compliance for any exporter and will significantly decrease the compliance costs for exporters across almost all tariff lines. Where RVCs have been retained, current exporters already have systems in place to record costs to determine content and no additional costs will be incurred. The impact of the proposal would be similar for both Australia and New Zealand. The elimination of RVCs and basing any retained RVC calculation on f.o.b. rather than factory costs in most cases will also make assessments of origin claims by the Australian and New Zealand Customs Services simpler.

Implementation of a CTC approach to ANZCERTA ROO would potentially allow a greater number of Australian and New Zealand manufacturers to claim origin, and thus receive preferential entry into the other country. It is difficult to estimate how much trade would benefit from the proposed changes as it is unlikely that all trans-Tasman trade currently subject to duty would enter duty-free under the proposal.

In recent years, the major Australian exports subject to duty in New Zealand have included plastics and chemicals, paper and paper products, fabrics, ceramic products, glass and glassware, metals and electrical machinery and equipment. While all groups will benefit from the increased transparency and simplicity of the revised ROO, exporters of plastics and chemicals and electrical machinery and equipment that make use of inputs that are not produced in Australia or New Zealand and for which there are no local substitutes available are likely to benefit from the adoption of a CTC approach. This resolves, for most sectors, the problems the earlier 'intermediate inputs' proposal attempted to address.

In addition, textiles, clothing and footwear and leather exporters on both sides of the Tasman may be aided by the proposal because these products have relatively high MFN tariffs in both countries and are less likely to be traded if a ROO requirement is not met. The more liberal ROO created by the proposal is therefore likely to increase trade in these goods, although the extent of this is difficult to gauge.

Costs

General criticism of the CTC ROO has rested on the concern that secondary criteria, such as regional value content requirements, will be introduced to minimise potential liberalisation and act as a form of hidden protectionism. This criticism is based on the experience of the ROO used by the European Union and United States of America in their trade arrangements, such as the United States' 'yarn forward' requirements, and the use of the technical language of the HS Code as the basis. However, protectionism is not intrinsic to CTC ROO and well designed rules can be very trade enhancing. The proposed ROO for ANZCERTA generally fall into that class. As noted, none of the proposed ROO have tightened requirements relative to the current regime.

The problems with the existing ROO arrangements, and the policy direction of Ministers, meant that any CTC ROO had to offer the potential for gains. The Government took AUSFTA and TAFTA ROO as the basis for discussions both with New Zealand and with Australian industry. The core change of tariff classification requirement of the ROO was checked to ensure industry thought it represented a fair

description of “substantial transformation”. This also provided consistency with Australia’s other FTA arrangements. The negotiated ROO provide for significant liberalisation by reducing or eliminating RVC requirements for most products. The basic approach to the remaining RVCs uses the AUSFTA 35 per cent build-up/45 per cent build-down criteria. These criteria are based around the prices paid for materials and received for the finished goods and are much less arbitrary in terms of what is included or excluded from the calculation. Furthermore, they expand the range of originating content and lower the threshold compared to the ex-factory cost approach, therefore making them easier to meet.

The only exceptions to these RVC criteria, where they are used, are for passenger motor vehicles and some clothing and finished textiles goods. The RVC for passenger motor vehicles is the lower 40 per cent build-down. The RVC for men’s suits will be 50 per cent ex-factory cost requirement (reducing to 45 per cent in 2010). Most finished textile products have an alternative rule to allow a more liberal change of tariff classification with an RVC of 55 per cent build-down. The change of tariff classification in these cases would allow, for example, the production of blankets and sheeting from dyed and finished fabrics which would not normally be considered manufacture.

For a limited number of tariff lines covering agricultural and processed food products, it is proposed that an RVC of 40 per cent on a build-down basis or 30 per cent of a build up basis be retained in conjunction with the CTC approach. The products covered include fruit juice, fruit and vegetable preparations and fats and oils. This approach was largely proposed by New Zealand but is also supported by the relevant Australian industries.

Accordingly, the ROO liberalise where possible, and maintain current arrangements for the most sensitive areas. Consistency is maintained by ensuring that the fundamental part of the ROO is consistent with Australia’s other FTAs.

The technical nature of the HS Code can limit the transparency of the arrangements, particularly for newcomers. However, as noted, the HS Code is used extensively in international trade. It is also unlikely that a business will need to know large parts of the CTC ROO; instead business can concentrate on the ROO that directly affect them.

The PC posited that a change in the model for ROO for an established trade agreement would result in large transition costs. The Government recognised this possibility, but was also aware that the new ROO are closely related to those of Australia’s more recent agreements and therefore either identical or very closely related to ROO already in use.

To minimise any impact in the short-run and allow time to adjust, the existing ROO will be maintained in parallel with the CTC ROO for five years. Australia and New Zealand have also agreed to review the operation of the CTC ROO within three years of them coming into effect. These provisions will put a floor under the potential costs to the changes by ensuring industry can become familiar with the CTC ROO while still having recourse to the current ROO if they think they will not meet them. Industry’s views on the operation of the CTC ROO and where, if any, problems exist that limit the potential gains from trade.

To the extent that they make it easier to claim preference on goods which currently fail to meet the ROO and pay the MFN tariff, CTC ROO will impact on Government revenues. This would affect a maximum of around \$2.9 million of duty collected by the Government, based on 2004-05 figures. Any trade created by the changes will

also increase revenue foregone however, since this trade is not currently taking place, it should not impact directly on the Budget.

Impact on Small Business

Any increased trade resulting from the implementation of this proposal is likely to have some competitive impact on the domestic industry of the importing party. For example, the Australian clothing industry is likely to see some additional competition from New Zealand clothing imports. Australian clothing producers will correspondingly benefit in the New Zealand market.

There may be scope for other small business that makes use of the regime to increase exports. For example, a small Australian manufacturer of fire-trucks has indicated that due to the need to use several key imported components that were unavailable in Australia, it failed to meet the ROO and was therefore unable to secure contracts in New Zealand by virtue of the duty impost.

VI. Current Policy and Legislative Arrangements

Government policy regarding the ANZCERTA ROO is administered jointly by the Department of Foreign Affairs and Trade and the Departments of Industry, Tourism and Resources (for industrial and mineral products) and Agriculture, Fisheries and Forestry (for agricultural and food products).

ANZCERTA ROO are described in ANZCERTA and side instruments. The *Customs Act 1901* and the *Customs Regulations 1926* implement the ANZCERTA ROO in Australian legislation. Changes to rules for determining origin would necessitate amendment of these Acts.

The Australian Customs Service has advised that there are no staffing or resource implications arising from the change.

VII. Consultation

Following the PC report, Australian officials consulted with Australian industry on the Commission's recommendations, which industry opposed (see V. Impact Analysis, Option 2). There was, however, some agreement that the existing ROO constrain trade.

Consistent with the direction provided by the respective CER Ministers of Australia and New Zealand, officials from the Department of Foreign Affairs and Trade (DFAT), the Department of Industry, Tourism and Resources (DITR), Department of Agriculture, Forestry and Fisheries (DAFF) and the Australian Customs Service (ACS) then discussed the proposal to adopt a change of tariff classification approach and the associated schedule with New Zealand officials. Australian Government officials also discussed the proposal with key industry associations. The proposal has also been promoted on the DFAT and DAFF websites and advertisements run in *The Australian* and the *Australian Financial Review* newspapers on 16 and 22 July 2005 respectively.

Australian industry groups were consulted extensively in the development of the proposal, which most supported, subject to final consideration of the schedule. These included the Distilled Spirits Industry Council of Australia (DSICA), Confectionery Manufacturers of Australasia (CMA); Dairy Australia, Wine and Brandy Corporation and Wine Makers Federation, Australian Industry Group, Australian Seafood Industry Council, National Association for Forest Industries, Australian Plantation Products and Paper Industry Council (A3P), Australian Pork, Queensland Sugar, Horticulture Australia, National Farmers Federation, the Australian Food and Grocery Council

(AFGC), the Plastics and Chemicals Industry Association (PACIA), Australian Electrical and Electronic Manufacturers Association (AEEMA) and the Federation of Automotive Products Manufacturers (FAPM). Indeed, some saw the proposal resolving a number of outstanding issues whereby preferential duty was obtained without substantial transformation. For example, DSICA argued that the current ANZCERTA ROO allowed bulk spirits to be transhipped through New Zealand. No significant changes were required to the draft schedules to finalise negotiations with these groups.

The Federal Chamber of Automotive Industries (FCAI) initially argued that there was no strong case for change as its industry it had no difficulty with current ANZCERTA ROO and it would not really provide additional consistency as the AUSFTA and TAFTA origin rules were not harmonized. However, FCAI argued that, should the CTC approach be adopted, a 50 per cent RVC should be required. After careful reflection and further consultation, Ministers agreed that, consistent with TAFTA, an RVC of 40 per cent should apply to vehicle and vehicle parts under ANZCERTA. New Zealand has no vehicle manufacturing industry and its parts manufacturers are well integrated with the Australian industry.

The TCF sector as a whole was initially strongly opposed to the proposal to adopt a CTC approach. However, after further consideration of the potential impact of adopting a CTC approach for trans-Tasman trade, the footwear and women's wear sectors, represented by the Council of Textile and Fashion Industries (TFIA) and the Footwear Manufacturers' Association of Australia (FMAA), agreed to the proposal, requesting in addition that any RVC requirements be removed. The Government also consulted with the Australian Carpet Institute, which accepted the position. The manufacturers of men's suits were most opposed to adoption of a CTC approach, and argued for the sector to be quarantined from any proposal. However, after further consideration, they also found there were benefits in the proposal and agreed to a CTC approach, subject to a secondary RVC requirement being imposed.

VIII. Conclusion

While the current ANZCERTA ROO do not serve as a major impediment to trade between Australia and New Zealand and 98 per cent of trans-Tasman trade gains preferential tariff treatment, changes in the structure and make-up of the Australian and New Zealand economies have resulted in them no longer being appropriate for most industry sectors. Key problems are the high administrative cost incurred as industry calculates whether a product meets the ROO and uncertainty with shifts in exchange rates and fluctuations in international prices of materials which can significantly affect an exporter's final cost structures. The current ROO also provide a disincentive to improve efficiency and reduce costs or use higher value imported materials if this is likely to adversely affect their ability to achieve the 50 per cent threshold.

The Government's objective in amending ANZCERTA ROO is to ensure that they recognise changing economic drivers as both economies seek to become more internationally competitive and that they do not act as a disincentive to trans-Tasman trade in goods. In particular, the Government's objectives in amending ANZCERTA are to lower compliance costs for businesses attempting to meet the ROO requirements to attain preferential market access and improve consistency between Australia's Free Trade Agreements.

Three options have been considered:

- no change;
- adoption of the Productivity Commission's recommendations to waive the 50 per cent factory cost requirement where Australian and New Zealand tariffs differ by less than 5 per cent and/or lower the 50 per cent threshold on the remaining goods in the short term and eliminate the requirement completely in the longer term; and
- adoption of the change of tariff classification approach.

Retaining the current ROO is not desired due to its inherent problems.

While the Productivity Commission study notes some advantages with the proposal to reduce, eliminate or waive the 50 per cent factory cost requirement, including reducing compliance and administration costs for industry and removing impediments to efficient sourcing of inputs, Australian industry expressed strong reservations about it. Industry saw the waiver as undermining the operation of the ANZCERTA ROO, opening opportunities for minimal transformation operations to get preference. Mere reductions in the threshold would not address the compliance and administration costs associated with the factory cost methodology nor provide a long term solution to threshold-related problems.

The third, and preferred approach, is a CTC method. It has many advantages, including that it reduces compliance and administrative costs; it enables the use of inputs not produced in Australia or New Zealand without adverse impact on the ability to claim origin; and is consistent with Australia's more recent trade agreements. Australian industry has generally expressed strong support for CTC ROO. The Government has also sought to minimise costs of transition by grandfathering the existing ROO for five years in parallel with the CTC ROO and committing to review their implementation within three years.

