PACIFIC BRANDS RESPONSE TO PRODUCTIVITY COMMISSION POSITION PAPER ON TCF ASSISTANCE: JUNE 2003

Pacific Brands response to the Productivity Commission's Position Paper is summarised in point form below. These notes form the basis of our presentation to the public hearings in Sydney, 12 June, 2003.

a) Restate

The key points of our original submission to the Commission were:

- clothing is the key policy issue: failure to address the adjustment challenges in this area will mean failure of the policy proposal overall given that it:
  - represents the great bulk of the industry employment;
  - has upstream survival implications for probably 60% of the remaining intermediate Textile industries;
  - is the labour intensive area most subject to low cost imports from developing countries as the tariffs reduce to minimal levels:and
  - is the sector subject to the largest tariff reductions under the Commission's proposals(both in amount and timeframe) as well as being the most at risk to the MFA type low labour cost import threat

- Orderly timetable of tariff adjustment to the 2015 minimal assistance end-point is achievable without unnecessary wastage of the current TCF sector through a refocussing of the current SIP style program towards the needs and challenges of the key clothing sector.

- The mechanics of the SIP style program post 2005 and how it relates to clothing is the critical issue.

b) Support (re P.C. Position Paper)

As a general observation, the P.C. position paper is to be commended as a balanced practical contribution to the TCF policy challenge post 2005. The Commission describes its broad approach as to:

"recommence tariff reductions...
"allow sufficient time for adjustment…
"continue provision of some transitional assistance…
"need for policy certainty".

We support this broad approach and in particular we support:

- the Commission's preferred timetable for tariff change as outlined in their Option 4
- the conclusion that "the objective of the current package to facilitate further tariff reductions through transitional budgetary support is appropriate"(p 68)
- the principle that " a further period of transitional budgetary assistance….would help facilitate adjustment to the reduction in TCF tariffs to the 5% target rate…"(p.XL)
- the observation that "simply rolling over the existing arrangements post 2005 would not be appropriate..(and)…changes are required to better facilitate the Government's objective of encouraging the TCF sector to become internationally competitive with lower levels of assistance.."(p.XL)
- the observation that in the absence of SIP induced adjustments, the effects of tariff cuts on TCF activity will be far greater in the clothing and knitted goods sectors than any other area of the TCF sector(Table E.3 p 203)
- a 10 year timeframe as a basis for maintaining industry confidence through orderly change in the critical clothing and related goods sector;

- a clearly defined end point and challenge in terms of no (or minimal) tariffs and no further sectoral assistance for any sector of the industry after 2015;
- adequate funding (both at the firm and sector level)to make the adjustments achieved meaningful and significant to meet the challenges of the timetable of reducing tariffs.

c) Critical (re P.C. Position Paper)

As noted the determining element of the post 2005 policy is the administrative delivery detail. In this key respect we are more critical of the Commission's policy efforts to date.

Tariff Detail

• ***Clothing Tariff End-point***; With respect to the tariff phase-down, we believe that, on the balance of industry costs and community benefits, a 10% tariff end point for clothing is preferable to a 5% end-point. However we believe that the adequacy of the positive assistance mechanisms, and how they relate to clothing activities, is the more important concern for a good policy outcome. As such we have focussed our response on assistance mechanics rather than debate this tariff end-point.
• ***Other Tariff Claims***. In response to certain tariff positions put by other interests in the TCF sector at the current hearings, we do not support the separation of tariff adjustment from the provision of transitional adjustment assistance. Our view is that acceptance of transitional adjustment assistance is conditional on the acceptance of lower tariffs, and that moves by any sector to avoid that responsibility automatically precludes them from access to transitional adjustment assistance. However we do support footwear interests seeking the acceleration of tariff reductions on their intermediate goods (ie footwear parts), and (as a significant supplier of furniture foam inputs) we support the concerns of the Furniture Industry Association as to the dilemma they face whilst intermediate textile duties exceed the end product assistance against rapidly increasing furniture imports.

Adjustment Assistance Detail

• ***Effective Mechanics for Clothing Adjustment Critical*** The major issue post 2005 is the effective delivery of the adjustment assistance and how it relates to the key clothing industry To date the Commission has undertaken minimal`assessment and consideration of the differing roles, needs and policy requirements of the differing sub-sectors within the TCF industry. There is obviously a strong commitment from industry to consider the trade-off between adjustment assistance and tariff reductions. However, the tariff reductions and associated import pressure is greatest on the clothing and related goods sectors, but under current rules the corresponding transitional assistance is least likely to apply to this area in need of most adjustment. Furthermore, the current delivery rules bear only partial relevance to the adjustment processes and drivers vitally required to enable significant clothing (and related) activities to make it into a no-duty environment. Put simply: the approach is correct, but the delivery mechanisms are not orientated to clothing industry circumstances, and as such both the trade-off and the outcome is sectorally skewed away from encouraging adjustment in the biggest and most "at risk" sector. Attachment 1 adds some further supportl to these comments as they reflect on this deficiency in the Commission's policy analysis to date

• ***Certain logical inconsistencies in the Commissions position on Adjustment Assistance detail*** Although, we address specific points of policy detail re adjustment assistance in section (f) of this submission, there are some general questions that need to be raised as to the Commission's position and approach. Firstly we agree with their direct link between transitional assistance and tariff reduction but do not understand why this linkage is discounted from 10 years to 8 years in the Commission's preferred policy package. Secondly, the Commission makes the judgement that the link between transitional assistance and tariff reduction should be reduced to "half strength" for all in the second 5 years because the "non clothing and related goods" will no longer be in transition having reached their end point at 2010. If there is a case for reduced funding in the second 5 years, we would have thought that this would be better implemented by reducing the coverage of the adjustment assistance to those in transition rather than spreading the funding reductions across all sectors whether still moving to the 5% end point or not

d)Respond

On pages 90 and XXXIII the Commission "seeks comment from participants on the advantages and disadvantages of each (of Administration Options A, B & C), as well as on any other design approaches that could improve on the current SIP". (p. XXXII). As noted above we would have liked more analysis at a sectoral level on which to consider these critical questions but base the following response on our experience as the major operator in the TCF industry

Pacific Brands supports Option A as the preferred approach provided certain key administrative issues outlined in this submission are addressed.

Pacific Brands does not support Option B because it relates only to one driver (value adding) and is based on an "incremental" notion measured against a historical base of little relevance in an industry (especially clothing) with massive underlying contraction potential. With respect to "incremental" we contend that the real issue is "what would otherwise have applied in the absence of the policy encouragement". Unfortunately, the measurement of this theoretical position is not administrable in practice and again the constraints of good administration and delivery rule out such options.

Pacific Brands sees some potential in Option C but not in the context of 5 years of the industry adjusting to the current SIP entitlement arrangements. The desire to develop a completely new policy approach has been a major weakness of policy moves in the past .We support the maximising of the investment firms have made in understanding the operation of the current SIP entitlement approach. For this reason alone we support serious attempts to work with the essentially strong SIP approach and correct administrative flaws along the lines suggested below.

e)Addressing Clothing Adjustment Needs Under Option A.

• ***Adjustment Policy Design Criteria*** Before commenting on delivery arrangements to "drive" desired structural change in the key clothing and related goods industries, we agree with the Commission's view that improvements to the current system need to be assessed against an appropriate design criteria. Rather than analyse the Commission's design criteria of p 88 we note the following as the determinants that will make us, and the adjustment policy, work together best to achieve an " assistance package for the TCF sector .. helping firms improve their viability at lower levels of assistance" (p.69):

1. *relevance to largest elements making-up the TCF sector* Apply some "significance test" in policy design to ensure policy proposals are getting through to the heart of the industry.
2. *relevance to the core sub- sectors most under threat* Cost disabilities and tariff cuts vary widely between sectors within TCF and "good policy"`is about addressing adjustment assistance issues in areas where it is most needed and where(and how) it has the most impact on the overall international competitiveness.
3. *relevance to the firms behaviour* As the Commission notes "provide a sufficient level of support to make a difference to firm behaviour" (p88)
4. *relevance and currency to day-to-day decision making* Policy designed to enable sufficient confidence to factor in adjustment assistance encouragement at the time strategic sourcing decisions are being made, not after-the-event.
5. *administrative simplicity* Design administrative mechanics that require minimal interpretation and judgement by both the applicant and the Government assessor.
6. *promote certainty and transparency*

- ***Drivers for a stronger more internationally competitive clothing industry*** As noted, current adjustment assistance arrangements are largely tailored for technical, capital intensive, areas like textile, leather and carpet activities. Drivers need also to be relevant to the key clothing industry if the post 2005 adjustment policy is to fully reflect its transition-to-lower-tariff role. As the Commission notes on page 10 there are a multitude of reasons for success and viability for clothing firms but the key drivers we believe should be addressed in post 2005 adjustment assistance measures are:

1. *value added* "Most successful manufacturers in developed countries have directed their efforts to high added value products…"(TCF Action Agenda p 38) "Higher value added products are not as vulnerable to price competition since consumers usually take factors such as product quality, design and service into account during their purchase decision"(p42)
2. *brand equity* Local production of even basic commodity style products can be long term viable if linked to strong brand equity .Pacific Brands experience is that if sufficient gross margin for otherwise basic products can be achieved through brand protection then these products will be maintained locally .It is rare that the delicate balance of customer service ,quality and brand image will be endangered by offshore sourcing if the brand equity can maintain sufficient margin to continue domestic sourcing. "All TCF companies will have to place a large emphasis on marketing to differentiate their products from cheap imported products"(TCF Action Agenda p40)
3. *product development* " Design is a very weak point in Australia, as most companies have not yet moved from basic products, with very little design input, to higher value added products which have a substantial fashion content…To address this, Werner says the corporate culture in Australia has to be adapted in order to make design a core competence of the textile and clothing industries" (TCF Action Agenda p 38)
4. *process improvement* "If Australian companies want to compete internationally, they must consider improving their operations by considering the advantages of a best practice approach. They should also look to innovation across their activities in management, design,production and marketing activities" (TCF Action Agenda p 47)
5. *investment* "Technical progress by investment in the latest machinery can be significant. Attention needs to turn increasingly to administrative effectiveness and logistics, the objective being increased flexibility and shorter lead times."(TCF Action Agenda p 38)

6.*industry rationalisation* Industry rationalisation is a driver for improved long term viability in itself whether applying in decentralised areas or not

- ***Improvements to SIP Administration to address these drivers*** In line with our support for the commission's Option A, we note the following administrative changes we believe will make the current SIP arrangements relevant and focussed on the drivers needed for positive adjustment in the core of the Australian TCF industries

1*. delink value add* Delink value add Type 3 support from its current application where it is limited to only those activities compatible with capital intensive drivers or those activities favoured by the "non-visual" innovation test. The direct encouragement of increased value adding in clothing is a key adjustment driver. If there is concern as to administrative restraint on this dimension then we would support a review of the current 5% to value added rate rather than restraint in coverage by linking to some other definitional requirement.
2*. encourage brand equity* Under Type 1 arrangements investment in brand equity (pro rated according to the level the brand is locally produced) should also be directly encouraged with a more open, all-media, definition of brand support than used in the limited areas of Type 2 currently. The targeting of this dimension could come from assessing media spend by brand and pro rata its audited sales per local (and not import) source, with an overall cap that the total audited locally based brand spend investment claimed per firm could not exceed 5% of local sales p.a.(and hence associated brand equity support funding per firm could not amount to more than 1% of their local sales level).

3 *encourage clothing product development* Currently product development encouragement is confined to technical innovation. Clothing design is generally only included in this definition to a very limited extent (mainly to the extent a fabric or other material property is developed by the apparel manufacturer operating as a defacto textiler and including the textile or ceramic plate etc in the garment). Either innovation has to be redefined to recognise the "visual nature" of fashion, or product development per se has to be encouraged with the definitional restriction of innovation replaced by a cap on the claimable expense level allowable. eg in a delinked program the product development claimable expenses could be also confined to 5% of local sales p.a.(and hence associated product development support funding per firm could not amount to more than 2.25% of their local sales level).

4. *encourage broad process improvement* Currently any process improvement requires approval as being innovative to the industry before it can be claimed under the Scheme. "Best practice process improvements "are not in themselves" innovative" (being application of known best practice) and under a strict interpretation do not qualify. We contend that best practice and process improvements new to the firm are desirable drivers for post 2005 adjustment in TCF industries and seek clarification to this effect in the delivery of any future adjustment assistance for TCF process improvement.

5*. develop industry relevant innovation definition* Currently the interpretation of "innovation" is the critical determinant of Government support for the non capital intensive clothing industry. As noted the interpretation of innovation in product development focussing only on "non-visual" and physical properties bears little relevance to the visually based clothing industries. Likewise we previously noted that an interpretation of innovation in process improvement limited only to concepts "new to the industry" means many productivity improvements (ie those involving concepts "new to the firm") will not enter into the adjustment assistance program.. We contend that

*the definition of “innovation” should be simplified to :“innovative means a new, improved or different product ,process or characteristic that involves an appreciable element of novelty” ;
*any future reference to s18(2) post 2005 should be changed to “However, an activity is not an eligible product design activity if it is directed at incorporating only cosmetic change to an existing product”; and
*any future reference to innovative process improvement should be in context of innovative to the firm .

6.*encourage* *industry rationalisation* We contend that industry restructuring and scale economies would be improved by de-linking the Type 4 & 5 restructuring encouragements from their current restriction only to regional areas

d) Responses to Administration Suggestions Raised In these Hearings.

A number of firms and organisations have suggested administrative changes to the current SIP scheme to apply post 2005 .For the reasons outlined previously in this submission we disagree with a number of these proposals especially when they distort funding away from the objectives and drivers for maximum adjustment by those most subject to the transitional pressures. We do not support the following suggestions:

- Type 1 Suggestion
  *increases in the rate of assistance to Type 1 from 20% to 30% of claimed investment
- Type 2 Suggestion
  *continued current limited application of Type 2 claims tied to innovation definitions not representative of drivers required for the core policy areas.
- Type 3 Suggestions
  *suggested changes from the conventional accounting ,economic and statistical measurement of value add as current applying in SIP
  *increase in the rate of Type 3 payment from 5% to 10%
  *removal of the cap on Type 3 payments(if still tied to Type 1 & 2 recipients only) see note on this issue at Attachment 2
  *continuation of the current position whereby value adding is only encouraged for Type 1 & 2 recipients.

g) Pacific Brands Policy Position

*Tariff Reduction Proposals (Pacific Brands Revised Position)

	2000	2005	2010	2015
Clothing	25%	17.5%	10%	5%
Textiles & Carpets	15%	10%	5%	5%
Footwear	15%	10%	5%	5%
Yarns	5%	5%	5%	5%

*Concurrent Adjustment Assistance Proposals

- Continuation of current SIP style program recognising the key role of the predominant clothing industry and directed at achieving a significant TCF sector in the minimal tariff environment post 2015
- 10 year time frame of adjustment assistance
- Funding rate at no less than current for 10 year period
- No reduction in funding rate in second 5 year period as it relates to those sectors still in transition to the 5% tariff end pont
- Improvement of the current SIP administration by :
    1. Better use of capping rules, rather than definitional restrictions, to limit potential overuse in individual claims
    2. Delinking Type 3 from "only when receive Type 1&2"
    3. recognise brand investment (pro rata by locally sourced sales)in Type 1,with expenses capped at 5 % to sales if required
    4. redefine innovative product development for clothing or replace innovation definition constraint, by cap on product development expenses per firms locally made sales
    5. redefine innovative process improvement in terms of "new to the firm" or remove innovation constraint on process improvement
    6. recognition of the strategic importance of increasing industry rationalisation by delinking types 4&5 from their current "regional only" circumstances.

Attachment 1

Notes re Tariff Pressure and Adjustment Assistance in the Key Clothing Sector

- **Clothing is the dominant core of the TCF Industries**

  *Clothing represents approx 50% of TCF employment (far greater if outworker FTE's are included) and about 60% of the manufacturing units involved

  *"Around 80% of Australian textiles fibres, yarns and woven fabrics are used as inputs into further production. - a larger proportion of which are absorbed by the clothing industry" (Industry Commission Textile Clothing and Footwera Industries Vol 1 1997 p 45)

  *Measured in terms of end product demand the TCF industries are comprised 60% Clothing (with Household Product 13%, Shoes 13% and Carpets 4%)

- **International Pressure for Adjustment is Greatest on Clothing**

  *Import penetration is high in clothing but most importantly these imports are dominated by low cost China sourcing (70% of clothing imports are China sourced,57% of footwear imports are China sourced, whilst only 21% of textile imports are China sourced and minimal levels of carpet imports are China sourced)

  *The added pressure on Clothing over last 10 years seen by dramatic increase in imports at the expense of local clothing production not witnessed in Textiles generally (Clothing imports increased 228% over the last 10 years whilst Textile imports increased only 38% over the same period)

- **Rate of Reduction in Tariffs is Greatest in Clothing**

  *Currently Clothing and related products are at 25% Duty; Textiles Carpets & Footwear are at 15% , Other Fabrics &Footwear Parts are at 10%. Between now and 2015 the Commission has proposed that all will move down to 5%. The adjustment pressure for clothing and related goods post 2005 is clearly greater than in other sectors .

  *When tariff reductions of recent years are also recognised (10 years ago Clothing rates were 55%) the rate of tariff reduction in clothing is even greater.

- **Access to adjustment assistance under current SIP rules weakest in clothing**

  * Year 1 SIP Results

	Share of Funding	$Per Head	%Per $Sales	%Per $ VA
Carpets	17%	$7,000	3.1%	9%
Other Textiles	44%	$3,000	1.9%	7%
Footwear	10%	$3,500	2.6%	8%
Clothing	26%	$850	1.1%	4%

*On the limited figures to 19/02/03 the year 2 share of clothing had decreased further from 26% to 16% of the $60 mil distributed to year 2 claims as of that date.

*Although we would hope more recent Year 2 figures rise from this 16% allocation to the core clothing sector, even at the 26% of year 1 it shows the application of current SIP rules to clothing policy needs are still disproportionately skewed away from clothing's critical role in the current industry and its critical future role as tariffs decrease further in clothing. The above picture is even more pronounced if it is recognised that to meet the definitional rules many of the clothing claims noted in these statistics are as "defacto textilers", and that some of the larger clothing firms cover claims for other sectors of TCF but are all included as Clothing in these AusIndustry statistics.

Attachment 2

Note re Removal of Cap on Type 3

Attach extract of earlier email to others on this topic:

‘ It seems to me a very simple proposition that

- if Type 3 is a matching grant up to the level of your total value added(ie capped at 100% of the firms value added level and not at 5% as current)
- and the combination of the Type 1&2 plus the matching Type 3 VA grant can not exceed 5%(ignoring roll-overs for simplicity)
- then the maximum type 3 amount is 2.5% of sales(matching the max type 1&2 grants of 2.5% of sales to reach the overall 5% to sales cap)
- AND therefore the only value add to sales you require to get this full access to type 3 is likewise 2.5% of sales.
- This is not an encouragement to value add but an incentive to get out of value adding as you are treated the same way as long as you have 2.5% or more value add to sales level (ie treated the same whether you have 2.5% value add in Australia or 75% value add in Australia).

As noted I believe the more defensible case for encouraging value added is to retain and focus on the capping (encouraging those businesses with less than 50% value-added-to-sales to increase this level to have the facility to access more under this type 3 provision),and to delink the encouragement of value added from only those situations where it is associated with SIP acceptable investment and innovation definitions(akin to the argument of why should type 4&5 only be encouraged when it is in regional areas) “