



Australian Government

**Department of Industry
Tourism and Resources**

Supplementary Submission to the Productivity Commissions Report Rules of Origin under ANZCERTA

General

Any alteration to the rule of origin (ROO) under ANZCERTA would be a policy decision taken by the government. The Department of Industry Tourism and Resources would have a role in advising its Minister in regard to that decision. It does not have a role in its own right in supporting or advocating any particular change. This submission is intended as a commentary on the Commission's draft proposals and should not be read as advocating any particular approach.

The Department considers the recommendations in the Commission's interim report would not necessarily improve the efficiency of resource allocation in either Australia or New Zealand and that the approach recommended for change to the ANZCERTA rule of origin could actually increase the potential for a sub-optimal allocation of resources.

An important problem with the draft report is that in proposing a general relaxation of the rule of origin, little weight has been given to the absolute tariff level applicable to a good (and hence the margin of preference available) and the issue of the duty applied to inputs.

The tariff level and margin of preference

The MFN level of tariff applicable a good that attracts preference might be taken into account in determining the rule of origin. The Commission has noted the decline in tariffs applied by both Parties since the inception of the agreement. This has meant that the preference at stake has declined across the board and to the extent that the ROO is a device for preventing mere transshipment of goods, there would less of an argument for maintaining a ROO that demanded high levels of transformation within the Parties.

However, the relaxation of the ROO implied by the draft recommendations is not related to the level of duty; but rather to differences in tariff rates on the traded products. Our analysis demonstrates that difference in tariffs on imported inputs is a relevant consideration, but we have not been able to identify any clear connection between the choice of threshold area content percentage and differences in tariffs on final products. There might be a presumption that a difference in rates on the traded goods will be reflected in the rates on inputs as well, but that connection is not demonstrated by the Commission.

The importance of duty on inputs

The Commission has not given any consideration in its draft report to the effects of duties on inputs. There can be an efficiency impact if the duty rate applicable to imported inputs varies significantly between the two parties. If the imported inputs for a product are exposed to a very low (or zero) rate of duty in one of the jurisdictions and are exposed to a significant duty in the other, then a commercial advantage can be available to the producer paying a low or zero duty on inputs which is not related to that producer's relative efficiency. In essence, the differing duties on inputs lead to different effective rates of assistance for producers of the same product in the same market. The Attachment to this submission illustrates the sort of distortion that can occur when the difference in duty rates on inputs is large.

That Attachment concentrates on cases where the rate of duty on inputs for the exporting producer is zero due to duty drawback. This is a special case of differential duties applying to inputs — but in the ANZCERTA context it is the most common since duty drawback is allowed to apply. As a broad conclusion, there can be a significant welfare effect¹ if

- there is a significant difference in duties applied to imported inputs; often when duty drawback applies; and
- the level of area local content required to qualify for preference is low.

Should we disallow duty drawback?

One partial response to this issue might be to disallow duty drawback for goods traded under preference but that would lead to its own problems

With tariffs now at a low level for most manufactures in both parties, the radical approach of disallowing duty drawback would not be appropriate when the problem created by the draft recommendations is only significant in the few remaining sectors with medium to high tariffs on inputs. Moreover, with both countries developing FTAs with a range of other partners, disallowing duty drawback would not, of itself, guarantee neutrality in the treatment of inputs even if MFN rates on the final products are equal.

Also, given that disallowance would not be a perfect solution, it would be difficult to justify the disruption to some enterprises that are currently claiming drawback in their trans-Tasman trade.

Other issues identified with the Current ROO

The interim report identified a number of other issues important in the choice of a ROO.

Cost of compliance and administration for business and Customs

There are costs associated with compliance and administration of the ROO. However, as noted by the Australian Industry Group: “existing evidentiary evidence requirements

¹ By and large the distortionary effects are only significant now in the textile, clothing and footwear sector because that is the only sector with high input tariffs and with significant production capability in both economies. That said, the Australian Auto industry has also expressed its preference for a continuation of a 50% threshold.

for ROO under CER are not viewed by industry as difficult to meet” (*AIG Submission*, page 7).

If change is thought necessary it is important to recognise Australia’s other FTAs and that these agreements will involve different mechanisms for the ROO. Any change to the ROO regime should take account of the international trend. As echoed by industry, there should be some regard for minimising the so called “spaghetti effect” of different ROOs while also reducing administration and compliance costs.

The Commission’s proposals (especially the connection with the ANZSIC), introduce a new and as yet untried approach would probably not ease the compliance burden for industry.

Impact on innovation and efficiency

Business can be faced with the dilemma that while reducing their labour and other process costs to make their products cheaper, and therefore more attractive to buyers, they may fail to meet to RVC threshold and lose the preference.

We note, however, that a very high proportion of trans Tasman trade meets the existing ROO and so there is a question of how significant a barrier the ROO is to efficiency improvement. In those identified cases where the achievement of production efficiency might run up against the requirements of the ROO, a process or physical transformation related method (like change of tariff classification) might be effective. The Commission’s approach, on the other hand, is to reduce or remove the effective RVC threshold across the board. We suggest that a balance needs to be struck. Indiscriminate reduction or removal of the threshold, without rigorous regard to ensuring that substantial transformation still occurs, increases the scope for abuse of the ROO and inefficient outcomes.

Disincentive to use high value imported material

As noted in the interim report the use of high value imported material can result in failure to meet the RVC. Any ROO that involves significant regional value content will incur the same bias toward low cost imports and consequently encourages production of lower quality goods. However, our comments on the impact of duty drawback are relevant here. Merely reducing or removing the threshold percentage without offsetting attention to other issues is not a satisfactory approach.

Sensitivity to exchange rate fluctuations

As is demonstrated by the interim report, and in various submissions, the current method is subject to fluctuations in the exchange rate. Sensitivity to exchange rate fluctuations will occur when an RVC is used to assess origin. As with high value imports and business innovation and efficiency, a change to price affects the formula used to determine origin. Again, we consider that a balance needs to be struck, and the solution cannot lie in broadly reducing or removing the percentage requirement.

Other Concerns with the draft recommendations

Definition of Manufacture (Interim Recommendation 1.3)

The Commission's interim report advocates redefining manufacture to a 'standard definition' based on the Australian and New Zealand Standard Industrial Classification (ANZSIC). The Department questions the efficacy of this recommendation and, on reading the submissions, is puzzled why the Commission thinks there is a need for change to the basis for determining whether manufacture has occurred.

The current definition of manufacture used in the agreement is broadly similar to the ANZSIC definition. It has been refined and clarified by Australian case law and, as such, the definition has a degree of stability. Any new definition would be subject to new interpretation issues, especially considering the brevity of the description in ANZSIC (see the box below).

As the Commission notes, ANZSIC was developed to ease the production and analysis of industry statistics. The objective of ANZSIC is to identify groupings of businesses carrying out similar economic activities and each grouping uses the economic activities which characterise the primary activities of businesses in that industry. As such, the intent of the ANZSIC system is not to establish substantial transformation or any other origin conferring test.

The Commission argues that ANZSIC is superior to the Harmonised System (HS) for determining 'manufacture' since the classifications in the HS have been developed for statistical purposes and not to confer origin. While the description of the HS is correct, the Commission does not seem to have recognised that ANZSIC is also a statistical classification system that is not designed to confer origin.

One apparent reason for the change that the Commission puts forward is the broader definition of 'manufacture' that the use of ANZSIC could allow. By incorporating activities such as simple assembly and the refurbishment or reconditioning of machines the ROO would move away from the principle of substantial transformation and thereby allow more goods to be traded preferentially. While that would be so, that increased preferential trade might well not improve welfare.

Also, the ANZCERTA does not currently rely upon any connection between the HS classification of goods and the determination of whether manufacture has taken place. There would be a connection if ANZCERTA adopted a change of tariff classification (CTC) approach to determining the necessary level of physical transformation — but ANZCERTA does not currently use that approach.

The change of tariff classification approach

The Commission's interim report discussed the possibility of CTC for determining transformation. The Commission notes that a CTC approach can be used for protective purposes and has been used in that way in some other agreements. Still, the CTC approach does have the advantage of giving certainty and is not inherently inferior to a broader transformation rule like the ANZCERTA definition of manufacture.

Indeed, in consultations over the proposed FTA with the United States, Australian industry has recognised the advantage of a CTC, or product specific, approach to determining origin. In our view it is not the instrument itself that is faulty; indeed, it has advantages provided it is used to provide a neutral description of the sort of transformation that occurs in industry when subject to MFN tariffs and rules.

In the context of any product specific rule, the problems of abuse do not arise inherently from the use of the tariff to define the transformation. In the wrong hands, use of change in ANZSIC class to define ‘manufacture’ or indeed as a mechanism to confer origin, would invite the same weaknesses as those attributed to the Change of Tariff Classification (CTC). Also, unlike the ANZSIC which would be unique to trans-Tasman trade, the HS (the basis of the CTC method) is a well established and widely recognised part of all trade. Furthermore, since imported inputs are already classified under the HS when entered, to impose a system that requires them to be mapped against the ANZSIC would impose additional administrative cost and give rise at times to uncertainty and expensive disputes.

Conclusion

The Department suggests that the Commission rethink its basic approach to the recommendations in the draft report. In our view, a balance needs to be struck between confining preferential treatment largely to the product of economic factors in the parties to ANZCERTA (which would suggest a reasonably high threshold percentage) while not placing the bar so high that production practices are significantly distorted just to meet the rule. The Commission should also take into account that failure to adequately capture substantial transformation in the ANZCERTA ROO would result in goods preferentially entering Australia and New Zealand which have undergone only minor manufacture.

Tariffs on the goods traded — and on the inputs used in their production — have declined dramatically in both parties since the inception of ANZCERTA. Indeed the efficiency of manufacturing worldwide has increased in part due to international trade in intermediate goods, and as such there may be an argument for reduction in the threshold applied to goods now produced in a fairly low tariff environment.

On the other hand, where tariffs remain significant—on output and inputs—there is also an argument, for reasons of efficiency discussed above and in the attachment, for retaining a substantial percentage threshold.

ATTACHMENT**Illustrations of the effect of differential treatment of imported inputs (including application of duty drawback)**

A distortion can be introduced under a free trade agreement where there are differences between members' tariffs on the inputs to goods that are traded at preferential rates. This distortion will be greater where the rule of origin grants preference with a low value added from the FTA area. A difference in tariff on imported inputs will very often occur when duty drawback is allowed on inputs to a good that is exported to the other partner.

Due to its effects in the FTA context, duty drawback is prohibited under more than half the FTAs around the world. Customs unions (like the EU) implicitly disallow duty drawback—all goods enter under the common tariff and can then be transferred free of duty between members. The original duty cannot be claimed back on account of export to another member. This approach obviates the need for any rule of origin for trade between members.

To illustrate the distortive effect of differentials in input tariffs, take the case of a finished good that faces a MFN tariff of 10% in both parties to an agreement and is produced using inputs that, if imported, would face a tariff of 10%. Let us also say that duty drawback is available and, for simplicity, that transport and transaction costs are negligible.

Table 1

Good exported from A to B		
	Costs in A	Costs in B
Imported inputs	\$50	\$50
Duty at 10%	zero due to drawback	\$5
Local factory costs	\$50	\$50
Other costs and profit	\$10	\$10
FIS price	\$110	\$115

Table 2

Good exported from A to B: producer in A less efficient		
	Costs in A	Costs in B
Imported inputs	\$50	\$50
Duty at 10%	zero due to drawback	\$5
Local factory costs	\$55	\$50
Other costs and profit	\$10	\$10
FIS price	\$115	\$115

The good imported into country B from country A in Table 1 would satisfy the existing ANZCERTA rule if A and B were, respectively, New Zealand and Australia. The producer in A clearly has an advantage over the producer in B in selling the good in B's market. In this situation there is no apparent difference in the efficiency of the producers. Indeed the producer in A could be less efficient than the producer in B (by up to \$5) and they would still be able to compete at the same price as the producer in B — see Table 2.

Were the situation in Table 2 to obtain, then as much as \$115 of B's GDP might be paid for the good produced in A when the same good could be produced at home for the expenditure of only \$110 of B's resources. There is a clear net loss for B through the diversion from domestic supply to supply from the FTA partner.

If duty drawback were not available, Table 1 would show price equality (FIS price \$115 in both A and B). Table 2 on the other hand would have A's price (\$120) above B's (\$115), in accordance with their relative efficiency.

If tariffs on inputs are very low, then the distortionary effect would also be very low and when transport costs are introduced there might not be any significant welfare loss. However, introducing freight costs into this example where the tariff on inputs is 10% would not alter the outcome. Given the average trans-Tasman cost for TCF of 3-4 per cent, the producer in A maintains its advantage over that in Bin Table 1, albeit at a lower level, while the impact on the situation in Table 2 means that the producer in A can still be less efficient.

The distortionary effect increases as the threshold level of local content declines. For example, let us say that the threshold were reduced to 20% (i.e. imported content could be 80% of the factory cost) in the example above and the manufacturer imported inputs up to that limit. The results become:

Table 3 (developed from Table 1)

Good exported from A to B		
	Costs in A	Costs in B
Imported inputs	\$80	\$80
Duty at 10%	Zero due to drawback	\$8
Local factory costs	\$20	\$20
Other costs and profit	\$10	\$10
FIS price	\$110	\$118

Table 4 (developed from Table 2)

Good exported from A to B: producer in A less efficient		
	Costs in A	Costs in B
Imported inputs	\$80	\$80
Duty at 10%	Zero due to drawback	\$8
Local factory costs	\$28	\$20
Other costs and profit	\$10	\$10
FIS price	\$118	\$118

Table 3 gives the base situation—in the presence of duty drawback, the producer in A has an \$8 advantage over its competitors in B. Table 4 illustrates the extent of relative inefficiency and the welfare loss that could occur if the value threshold were so low—the producer in A can have costs up to 40% higher than the producer in B and still be competitive in B's market.