Supplementary Submission by the Central Districts Federated Clothing, Laundry and Allied Workers Union on the proposed Hong Kong free trade and investment agreement

Tariffs and Rules of Origin

This Union provided Feedback and Comments (dated 1 June 2001) to MFAT's **Initial Analysis of the Bilateral Trade and Economic Relationship as Background to a possible "Closer Economic Partnership" Agreement**.

In that feedback we expressed our opposition to the proposed NZ HK CEP Agreement.

We called for a moratorium on the negotiation of this and any other CEPA until a consistent and coherent fair trade policy linked to economic and social development is negotiated. We called for a full social and economic impact analysis of the proposed CEPA on the TCF manufacturing sector.

This supplementary submission is presented to reinforce our initial submission by presenting further evidence regarding tariffs and Rules of Origin (ROO).

The Union's concerns in this regard are on two fronts: first, that the rules ensure that goods are indeed largely made in Hong Kong, and second that the rules are enforceable.

The following takes into account information presented and subsequent discussion at the MFAT/Customs/Ministry for Economic Development meeting on ROO in Christchurch on 5 July.

Nature of the ROO

We have major concerns regarding Hong Kong's provision in its ROO called the "Outward Processing Arrangement" (OPA). This is described in the additional documents available from MFAT mentioned in its initial discussion paper, and was outlined in the 5 July meeting in Christchurch.

The paper provided by MFAT called "The Hong Kong Certificate of Origin System" describes OPA as follows:

> "The OPA enables registered factories to subcontract outside Hong Kong the subsidiary or minor finishing processes for products without affecting their eligibility for attaining Hong Kong origin status for the goods concerned. All goods covered by the OPA must have already undergone the origin-conferring manufacturing processes in Hong Kong. …"

The purpose was described at the 5 July meeting as "To help manufacturers in Hong Kong to lower the cost of production and enhance the competitiveness of Hong Kong's exports by making use of the lower production cost of the nearby areas".

To take an example from outside the TCF sector that makes the point clearly, consider the case of a plastic doll. The substantial transformation process is the pressing of the doll's shape from raw plastic materials. On a suitable machine, that may take seconds and cost cents. The real cost is in the "subsidiary or minor finishing processes" of dressing and decorating the doll in various ways. If those "minor" processes can take place outside Hong Kong after the origin-conferring substantial transformation process, then most of the cost can be transferred to low-cost labour sites.

Indeed, that is how the Hong Kong authorities have deliberately designed their Rules of Origin. To quote from the Minutes of a meeting of the Hong Kong Legislative Council Panel on Trade and Industry, held on Tuesday, 4 June 1996:

> 16. Mrs Rebecca Lai briefed members on the revision of Hong Kong's origin rules for cut and sewn garments which would be implemented on 1 July 1996. The revision would change the existing origin rules from "cutting and sewing" to "assembly of parts into garments" and would bring the system in closer alignment with the revised US origin rules and the origin criterion adopted by the European market. The harmonisation of origin rules with major trading partners would benefit the garment trade and industry as a whole. The revision would also facilitate the industry in making better use of the Outward Processing Arrangement whereby cutting and minor sub-assembly processes could be taken in places outside Hong Kong where costs were lower. Furthermore, it would eliminate the need to invest in different modes of manufacturing to cater to the requirements of different markets, thus enhancing the competitiveness of the local garment industry.
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> 17. Mrs Lai stated that the Government was aware of the possible impact on the labour front as some workers engaged in the cutting process might be displaced as a result of the change of origin rules. The Government would make every effort to provide suitable retraining for these displaced workers.
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> 18. Members welcomed the revision of origin rules since a broadly harmonised criterion with major trading partners would reduce restrictive effects, enhance competitiveness and provide a better trading and investment environment. They opined that the displacement of "cutting" workers would be offsetted by the corresponding increase in the number of sewing and transportation workers required as a result of the change of origin rules. The Deputy Chairman urged the Administration to arrange for the retraining of displaced workers.

Hence a possible scenario in clothing manufacture is

1. cutting and some sewing in a third country (e.g. China, Bangladesh…)
2. assembly of pieces and just sufficient sewing in Hong Kong to "substantially transform" the product into its final form for ROO purposes
3. completion of sewing, and finishing, in a third country under OPA.

Both the first and third stages could be substantial.

A garment is regarded as of Hong Kong origin by the Hong Kong authorities, according to their ROO, if parts are sewn into a garment in Hong Kong (see the paper distributed at the 5 July meeting). That allows (a) cutting and significant sewing of parts in a third country in the first stage, and (b) a garment to be regarded as "finished" when it still has considerable work to be done on it.

According to the information presented by Customs on 5 July, the work that could be left undone in Hong Kong on the "finished" garment and be carried out elsewhere under the OPA include:

- Beading
- Binding of edges
- Bleaching
- Buttoning (including button-holing, snap fastening, button wrapping, frog-making, fixing and fastening, etc)
- Checking/Inspection
- Hand/Machine Embroidering
- Inserting belt onto garment, elastic band into the waistband, joining the ends of elastic band
- Labelling
- Overedging at shoulder line, neckline, armholes, side vents, back collars, front placket and sleeve seams etc
- Packing
- Pressing (Ironing)
- Stringing of draw-string
- Trimming
- Unroving of surplus portions at assembled edges
- Unstitching of sleeve and side seams, pocket seam, side vents (for embroidery process)
- Washing (with special treatment, eg. Boiling)

Many of these are time-consuming operations in their own right; if several of them are carried out, they will shift a large part of the final cost of the garment out of Hong Kong (like the plastic doll analogy).

By including (and if necessary inflating) "factory costs" such as supervision, design and royalty payments (perhaps to related parties), the "local content" can with little difficulty be increased to 40% (or whatever local content requirement is set for Hong Kong, if there is any). The total cost will then be little different from importing the whole product directly from China, after adding markups reported to be between 28% and 34%[1], and the return to the manufacturer can be very similar. However it will save 19% on New Zealand tariffs.

Enforcement

We have major concerns about the enforceability of any rules of origin. If they cannot be enforced, then we are effectively zeroing tariffs to China and a score of other countries which Hong Kong traders use to contract out their orders.

[1] "Intermediaries in Entrepôt Trade: Hong Kong Re-Exports of Chinese Goods", by Robert C. Feenstra Department of Economics, University of California, Davis and National Bureau of Economic Research (NBER), and Gordon H. Hanson, Department of Economics and School of Business Administration, University of Michigan and NBER, December 2000. Also published as NBER paper W8088.

We have evidence from a number of sources that justifies our concerns. Similar concerns were aired by a number of those present at the 5 July seminar, and, we are informed, at the 6 July seminar in Auckland.

U.S. Customs Service and Congress

(Note: all the U.S. sources quoted below can be supplied on request.)

In a March 1999 publication by the U.S. Customs Service, "Trade Compliance Risk Management Process" (http://www.customs.gov/imp-exp2/pubform/tradcomp.htm), it is stated that it has found

> "Serious problems with textile transshipment through Hong Kong — Cooperative efforts with the Hong Kong Ministry of Trade resulted in 64 transshipment convictions and 15 export license suspensions."

where "transshipment" in this context means illegal re-exports of goods (e.g. from China, claiming they are from Hong Kong).

Every six months, U.S. Customs publishes a list of "Foreign entities violating textile transshipment and country of origin rules". For the six months ended 30 September 2001, it listed 23 companies. All but three were from Hong Kong (the remaining three were from Macau). U.S. Customs was also soliciting information regarding the whereabouts of a further 11 foreign entities concerning alleged violations, all but one of which were from Hong Kong (the remaining one being from Macau).

A further U.S. Customs report dated 28 June 2001 (TBT-01-001-03, http://www.cebb.customs.treas.gov/public/cgi/cebb.exe?mode=fi&area=13&name=T-TBT190.TXT) lists 392 "Hong Kong Convicted Factories" whose shipments would be detained by U.S. Customs because they had been "convicted, penalized, and/or excluded from entry because of transshipment". Nine of these companies had been added since the last report on 1 May 2001, and 67 had been convicted multiple times.

The American Textile Manufacturers Institute, in an unsuccessful U.S. Supreme Court writ against two Hong Kong companies it considered had been engaged in such transshipments, stated:

> "The transshipment of garments from China to avoid quota limitations is a major problem. The United States Customs Service has estimated that the value of Chinese-made garments declared to be the products of other countries ranged between 6.4 and 10.7 billion dollars in 1992. Unraveling The Mystery: Following the Thread of PRC Apparel Imports, United States Customs Service, December 1994, at 1."

Because of this "major problem", U.S. Customs has put considerable effort into enforcement measures including inspections of factories in Hong Kong using "Textile Production Verification Trips (TPVTs)".

A U.S. Congressional Research Service Report for Congress (RL30555: China-U.S. Trade Agreements: Compliance Issues, by Wayne M. Morrison, Updated September 1, 2000) stated:

> "China is a major source of U.S. textile and apparel imports. Chinese textile and apparel exports to the United States are limited by U.S. quotas established under a bilateral agreement with China. The most current agreement was reached in February 1997 and is effective over four years.
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> The U.S. Customs Service has found evidence in the past that China has attempted to circumvent U.S. quotas by transshipping Chinese textile and apparel products through Hong Kong and Macau as well as through a number of countries, to the United States using false country of origin labels and through mis-classification of textile and apparel products.
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> In July 1993, then-USTR Mickey Kantor announced the creation of an interagency task force to fight textile and apparel transshipments. He estimated that such transhipments from China alone totalled $2 billion annually. During 1993 and 1994, U.S. officials sought to include specific enforcement provisions against transhipments during negotiations to extend the U.S.-China textile and apparel agreement. Under the threat of reduced quota levels, China in January 1994 agreed to a textile agreement allowing U.S. officials to inspect Chinese factories and, if China repeatedly circumvented the agreement by shipping goods through other countries, impose penalties against Chinese quotas equal to three times the amount of the transshipment.
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> Evidence of transshipments has led the United States on a number of occasions to reduce China's textile quotas on certain products. Between 1994 and 1996, the United States imposed $80 million in charges against China's textile quotas, including approximately $19 million in punitive triple charges against China's 1996 quota allowance. The 1997 agreement also allowed the United States to impose triple charges if evidence of extensive transshipment was found. On May 5, 1998, the USTR announced that it would impose $5 million in triple charges against China's textile quotas due to persistent Chinese textile transshipments. A USTR official testified in June 1998 that the Chinese government 'appears to be making progress in preventing transshipment.'"

The U.S. Customs' 1999 Textile Transshipment Report (http://www.customs.ustreas.gov/quotas/ttr/pg7.htm#Hong Kong) reported:

> "Joint observation visits were conducted with Hong Kong officials in late January 1999 and early September 1999. The first visit found 27 of the 55 factories visited suspected of being involved in transshipment, or close to a 50% suspicion rate. The second visit found 24 of the 51 factories visited suspected of being involved in transshipment, again close to a 50% suspicion rate. This count does not include the factories that were referred for a pre-issue check or factory audit check, which would raise the suspicion percentage even higher. This suspicion finding rate has been consistent with previous visits. If the enforcement measures being taken by Hong Kong were having an im-

> pact, you would expect to see an improvement in our visits and a lower percentage of companies suspected of transshipment.
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> Finally, in 1999 U.S. Customs officials in Hong Kong transmitted the names of an additional 124 factories convicted of transshipment, bringing the total number published on the administrative list since the initiative began in 1997 up to the end of 1999 to 364. Of the 364 factories that appear, 56 have been convicted multiple times for textile transshipment, some as many as four times."

A "Textile Clearinghouse" has been established to collect and monitor data on such cases. For example it monitors the activity of over 600 factories that have been identified as closed, unable to produce production records or illegally transshipping. It analyses and monitors the activity of over 550 foreign entities published in the Federal Register or in administrative notices for a number of reasons such as inclusion in the six-monthly lists mentioned above, or conviction in Hong Kong of false country of origin claims. (see http://www.customs.ustreas.gov/quotas/ttr/pg5.htm)

Other sources

Though the U.S. Customs Service monitoring is evidently ongoing, we also note that as recently as 13 June 2001, the *Emerging Textiles* web site (http://www.emergingtextiles.com) reported:

> Hong Kong will again strengthen its fight against illegal textile transshipments, the *South China Morning Post* today reports. According to the Hong Kong-based newspaper, the Textile Task Force has been expanded from 20 to no less than 60 officers. The Task force was set up last year to control export operations at cargo entry and exit points.
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> Under continuous pressure from the US administration, Hong Kong intends limiting exports of textile and apparel goods fraudulently benefiting from Hong Kong's origin although produced in neighbouring China.
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> As requested by Washington, Hong Kong customs also intensified last-minute inspections of garment plants. In the last years, numerous joint visits by the US and Hong Kong customs have also been organized. Following those missions, the US administration established lists of companies condemned for having shipped products by illegally using the Hong Kong origin, or only suspected of breaching the local 'import & export ordinance'.

While it is of course comforting to know that enforcement efforts are being stepped up, the fact that this is necessary a decade after strenuous efforts by U.S. Customs, with resources many times those of New Zealand Customs, only reinforces our concerns that any rules are unenforceable in practice.

In this connection, we also note the observations of Richard Leary of the Exporters Institute, speaking from many years experience in the area, who does not believe New Zealand Customs can effectively enforce rules of origin. He notes the huge volumes of traffic through Hong Kong, mainly from China, "a constant stream of container trucks to and from the China border. A second source is the never ending parade of great

barges with their own cargo derricks, carrying maybe a dozen forty foot containers each". He says:

> Goods passing through Hong Kong from all over the world can be freighted to New Zealand with no check by Hong Kong authorities. I have trekked all the Hong Kong ports – some 20 of them, in an area smaller than greater Auckland yet transferring 10% of the world's seaborne freight – and I see no controls that would serve our interests.
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> *Independent, The Exporter*, 20 June 2001

It is interesting that U.S. Customs sees similar problems with Singapore. The American Textile Manufacturers' Institute is opposing the Singapore-U.S. Free Trade Agreement currently under negotiation, for among other reasons:

> "Singapore has one of the world's worst records in preventing transshipment and working with U.S. Customs. Singapore is one of only two countries in the world that has consistently refused to allow U.S. Customs teams to inspect factories suspected of transshipments (China is the other). In the single visit that Singapore agreed to in December 1999, U.S. Customs officials found that one-quarter of the manufacturers had major inaccuracies in their record keeping and that "a lot of traffic in finished garments (from Malaysia) is going across the border into Singapore and (is) exported as 'Made in Singapore'." It also noted that "Singapore Customs Import and Export permits were found to consistently include false statements and omissions with regards to country of origin." Indeed, U.S. Customs found that most of the plants it visited were incapable of producing the goods that were being exported to the United States as being "Made in Singapore.""

Echoing concerns we have expressed, it says:

> "An FTA with Singapore would essentially offer Indonesia, one of the world's largest apparel exporters, to ship apparel duty-free to the United States. With one of the world's largest ports, Singapore would become a funnel for billions of dollars of duty-free, transshipped textile and apparel exports from Indonesia, China, India and others."

(Letter to U.S. Trade Representative, 14 December, 2000; submission to United States International Trade Commission, 3 January 2001; "Q&A on a Potential Free Trade Agreement with Singapore". See http://www.atmi.org/EconTradeData/tradeissues.asp.)

Whatever ROO is negotiated with the Hong Kong authorities, we do not find credible any contention that New Zealand's small and already stretched Customs service can succeed where the U.S. counterpart has encountered enormous difficulties.

Neither is it clear to us what the objective of the ROO negotiations will be. If it is simply that the ROO be enforceable, then (even in the doubtful event that it could be enforced) there could be substantial duty-free imports from Hong Kong, severely damaging the local industry. If it is to retain the current level of TCF imports of "Hong Kong origin", to prevent damage to the New Zealand industry, then Hong Kong is unlikely to see any gain to them and so would find the position unacceptable. In its "Consultation Document" on the possible CEP, the Hong Government stated that it has "a keen export

interest" in the clothing and footwear sector. While officials at the 5 July meeting stated that Hong Kong's real interest in the CEP was on wider issues, we find it hard to believe that it would be satisfied without a concrete result in such an important area. If it conceded in this area, our concerns in other areas – such as seeking deeper concessions on public services in the Services negotiations – would be further heightened.

Data

Our above concerns are further reinforced by an initial analysis of clothing manufacturing data in Hong Kong, the U.S., and New Zealand. We refer to the following table.

Clothing, including footwear, manufacturing labour productivity

1999	Hong Kong	New Zealand	U.S.A.
Production ($NZ million)	18,110	1,450	48,185
Number employed (FTE)	58,490	13,002	675,000
Productivity: Production/employee ($NZ000)	310	112	71
Ratio of productivity to Hong Kong	1.0	2.8	4.3

(See the text below for sources and definitions.)

The differences in labour productivity between Hong Kong, on the one hand, and New Zealand and the U.S.A. on the other, are exceptional. Each Hong Kong clothing worker apparently produces about three times as much (by value) as a New Zealand worker and four times as much as one in the U.S.A. There are a number of possible explanations, including:

1. That ex-factory garment prices, or more specifically those declared to Customs, for Hong Kong products are much higher than for New Zealand or the U.S.A. That seems most unlikely.
2. That productivity is on average higher in Hong Kong than New Zealand or the U.S.A. because of better machinery, skills and production techniques. This could be true, and may well be a contributing factor. However, it is difficult to believe that it could account for more than a small part of the large differentials to both countries.
3. That compared to New Zealand and the U.S.A., a much larger part of the content of "Hong Kong" clothing output is not created in Hong Kong, but is carried out elsewhere, either through imported content or "outward processing". If this is the principle explanation then the data suggests that only a quarter or a third of the content of Hong Kong products is actually produced by Hong Kong labour.
4. That there is a high degree of fraud in declarations of Hong Kong origin.

Only the third and fourth explanations seem capable of explaining the size of the differences. In other words, the Hong Kong ROO and enforcement (respectively) are real and systemic problems. If tariff-free imports are permitted then those competing New Zealand clothing manufacturers that survive will be increasingly forced to emulate Hong Kong in raising the proportion of the manufacturing process performed outside New Zealand, at the expense of work and jobs for New Zealanders.

In making these points, we acknowledge that the data values can only be regarded as indicative because of differences in definitions. However the magnitude of differences in productivity mean that improving the quality of the data seems unlikely to change the conclusion. The data for New Zealand come from Statistics New Zealand's Annual Enterprise Survey, for "Wearing apparel and footwear manufacturing", ANZSIC groups C224, C225, C226, 1999. The U.S. data come from "Gross Domestic Product (GDP) by Industry Estimates" for 1999, from the U.S. Department of Commerce, Bureau of Eco-

nomic Analysis, Industry Economics Division, and covers manufacture of "Apparel and other textile products". In either case, using the labour productivity for the entire TCF sector would not materially change the conclusions.

The differences in the data for Hong Kong tend to strengthen our conclusions. First, domestic production data for Hong Kong is not readily available, so the data reflects only *domestic exports* (i.e. exports that are given the status of "Hong Kong origin" by the Hong Kong ROO). It therefore underestimates total Hong Kong production. Number employed is used rather than full-time equivalents, underestimating production per FTE. The source is Chapter 6 of Hong Kong's 1999 Year Book (http://www.info.gov.hk/hkar99/eng/index.htm).

Average exchange rates for 1999 were used to convert to New Zealand dollars.

Conclusions

We have presented strong evidence from a number of sources – official, experienced observers, and statistical – that strengthen our initial concerns regarding TCF imports from Hong Kong.

There is heavy use of low-cost non-Hong Kong manufacturers in "Hong Kong origin" garments, which would cause severe damage to New Zealand manufacturers and jobs if allowed in tariff-free. In particular, the "Outward Processing Arrangement" is a huge loophole in the current Hong Kong ROO. Our concerns are both with third-country processing *before* the garment is "created" in Hong Kong, and with processing occurring afterwards under OPA.

Whatever ROO can be negotiated to take account of these concerns (and we think it is unlikely that Hong Kong would agree to one that does), we have even greater concerns about enforceability. Given the demonstrated inability of the U.S. to enforce the Hong Kong ROO over a decade and more, it is not credible to claim that New Zealand Customs, even with the cooperation of Hong Kong and U.S. authorities, can enforce potentially stricter ROO.

These considerations reinforce our opposition to the proposed agreement with Hong Kong which we submitted in June.