SPARTECA (TCF Provisions) Scheme

MID-TERM REVIEW

Final Report
1 May 2008

The Department of Innovation, Industry, Science and Research, as Program Administrator of the SPARTECA (TCF Provisions) Scheme, the Department of Foreign Affairs and Trade, AusAID and the Australian Customs Service prepared this document.

Its purpose is to report on the effectiveness and impact of the Scheme.

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EXECUTIVE SUMMARY

The SPARTECA (TCF Provisions) Scheme (S-TCF) complements the existing South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA) treaty by providing an extra method for TCF products that do not meet the required local area content level (under SPARTECA) to enter Australia duty free. As part of the Australian Government's decision to extend S-TCF from 2004 to 2011, a mid-term review of S-TCF was to be carried out.

The review considers the Scheme's effectiveness. Two preliminary observations were made based on an analysis of participants' Excess Local Area Content (ELAC) registers and a technical visit to Fiji undertaken by Australian Government officials in October 2007: i) the quality and accuracy of ELAC registers could be improved; and ii) the permanent removal of the deeming provision could be supported. The review made the following findings in regard to each of the Scheme's objectives.

1. **Encourage trade in TCF between Australia and Forum Island Countries (FICs) and between FICs**.
   Since the 2004 extension of the Scheme, exports of TCF goods from Fiji to Australia have declined in both volume and value. Nevertheless, it appears that Fiji's reliance on Australia as a TCF market is increasing following a dramatic decline in exports to the US.

   It is also apparent that S-TCF continues to provide a cost advantage to Fiji firms. This advantage, combined with the industry's strengths, allows it to continue to effectively compete with low labour cost countries in specific market segments.

   Furthermore, S-TCF has had little negative impact on Australian suppliers of fabric, with Australian fabrics continuing to remain an important input into the production of garments in Fiji.

2. **Encourage increased diversity in the manufacture of TCF goods in FICs**.
   The Fiji TCF industry has diversified very little, if at all, since the introduction of S-TCF. The Fiji TCF industry continues to focus on the assembly of clothes, particularly woven garments.

3. **Encourage FICs to market TCF goods and services to markets outside the confines of SPARTECA.**
   Following a dramatic decline in exports to the US, the two largest markets for Fiji TCF goods are now Australia and New Zealand (both SPARTECA signatories). These two markets represented more than 90% of Fiji's TCF exports in 2006. Even though manufacturers are exporting to other markets, there appears to be some reluctance on the part of some Fiji manufacturers to engage new markets.

The mechanism by which third country materials may be included as local area content under S-TCF was also examined in the context of the review. Australian government officials assessed a number of options based on existing trade agreements. Analysis of these options revealed that they would ultimately be unfeasible, with the interim Government of Fiji accepting that the proposal would not proceed.

INTRODUCTION

Purpose

In 2004, the Australian Government decided to extend S-TCF until December 2011. As part of that decision, the Government directed that a mid-term review of S-TCF be conducted. In accordance with this directive, from December 2007 to March 2008, Australian Government officials carried out a review of the effectiveness of S-TCF, including its impact on the trade and manufacture of TCF goods in Fiji and options for including third party fabrics as local area content under S-TCF. This report sets out the findings of the mid-term review.

Background

S-TCF commenced on 1 March 2001 and was designed to minimise the impact of the cessation of the Import Credit Scheme (ICS) on Forum Island Countries (FICs). This was in line with the Government of Australia's and the Government of Fiji's commitment to develop a World Trade Organization (WTO) friendly arrangement in place of the ICS. S-TCF complements the existing SPARTECA treaty by providing an alternate method for TCF products to enter Australia duty free.

Under the existing SPARTECA arrangement, goods can enter Australia duty free if the allowable factory costs are greater than or equal to 50% of the ex-factory cost involved in manufacturing the product. S-TCF enables companies to utilise Excess Local Area Content (ELAC) points accrued from the manufacture of certain TCF products qualifying under SPARTECA to help meet the content requirement for otherwise non-qualifying goods.

The first review of S-TCF was completed in September 2001 and recommended that no changes to the operation of S-TCF be made. It also noted that more reliable trade data and compliance arrangements would enable better assessment of S-TCF.

The second review was released in June 2003 and recommended that possible options for improving the effectiveness of the Scheme should be explored by the Australian Government. The review also recommended the Government of Fiji make a greater effort to publicise the Scheme whilst increasing its audit and compliance monitoring.

In response to a request from the Government of Fiji in 2005 for further concessions to S-TCF, the Australian Government agreed to a package which included:

- a reduction from 35% to 25% in Minimum Local Area Content (MLAC), to come into effect no earlier than 2008, subject to Fiji meeting productivity, training and audit and compliance requirements;
- the removal of the deeming provision on a trial basis; and
- a review, in consultation with the Australian and Fiji TCF industries, of costs allowable for inclusion in the calculation of MLAC.

S-TCF was originally scheduled to end on 31 December 2004. However, in August 2004, the Australian Government subsequently decided to extend S-TCF until

31 December 2011. As noted above, as part of its decision to extend S-TCF, the Australian Government directed that a mid-term review of S-TCF be conducted.

Terms of Reference

The terms of reference for this review (Appendix 1) were provided to the Government of Fiji and the Council of Textile and Fashion Industries of Australia. Both Parties were encouraged to consult with their relevant stakeholders to provide input into the review.

This review assesses the effectiveness of S-TCF with respect to its stated objectives to:

i. encourage trade in TCF between Australia and FIC and between FICs;
ii. encourage increased diversity in the manufacture of TCF goods in FICs; and
iii. encourage FICs to market TCF goods and services to markets outside the confines of SPARTECA.

It also examines the impact of the trial removal of the 'deeming' provision and options for including third party fabrics as local area content under S-TCF.

It was decided that clothing made from wool or wool blend fabrics would continue to remain excluded from S-TCF and that the mid-term review would not cover this element.

OBSERVATIONS

Use of ELAC Points under the Scheme

Under the Scheme, Excess Local Area Content (ELAC) points are generated on eligible TCF goods whose Local Area Content (LAC) is more than 70%. Other goods with a LAC of 35% to 49% may use those points to qualify for duty free entry into Australia under the Scheme. When applying for re-registration under S-TCF, participants are required to provide a copy of their ELAC points register. Based on the ELAC registers provided by manufacturers when applying for re-registration in 2007, approximately 6.3 million points were generated in the year ending August 2006.

Full interrogation of point usage is inherently difficult due to the varying quality of the ELAC registers provided. However, there have been undertakings given by Fiji manufacturers to further utilise S-TCF computer programs (SIMS and ELAC MS) to generate electronic ELAC registers which should make future analysis more successful. Nevertheless, there is anecdotal evidence that manufacturers continue to generate more ELAC points than are required.

Observation 1: Quality and accuracy of ELAC registers could be improved to allow for further interrogation.

It has since been agreed by S-TCF participants that the use of an electronic ELAC register will be made mandatory, which will improve the quality of ELAC registers provided.

The Deeming Provision

In August 2007, the Australian Government agreed to the removal of the 'deeming' provision from the S-TCF terms and conditions. The deeming provision required that eligible goods with a LAC that exceeded or equalled the MLAC but was less than 50% were deemed to have a LAC of 35% (the prescribed MLAC level). By removing the deeming provision, the required number of ELAC points needed to bring points up to a notional 50% local area content reflected the actual amount of local area content rather than the deemed 35%.

Testimony received from participants during a technical visit by Australian Government officials to Fiji in October 2007 revealed that some participants had been using significantly fewer ELAC points since the deeming provision had been removed. This appears to indicate that the majority of the products that are using ELAC points are at the upper end of the 35% to 49% LAC levels.

Consultations with the Australian TCF industry revealed that it had not experienced any adverse effects from the removal of the deeming provision. As a result, the permanent removal of the provision from S-TCF would be supported by both

Australian and Fiji industries. However, it remains unclear as to what benefit this may have to the Fiji industry considering some participants are already generating an excess amount of ELAC points.

Observation 2: The permanent removal of the deeming provision would be supported.

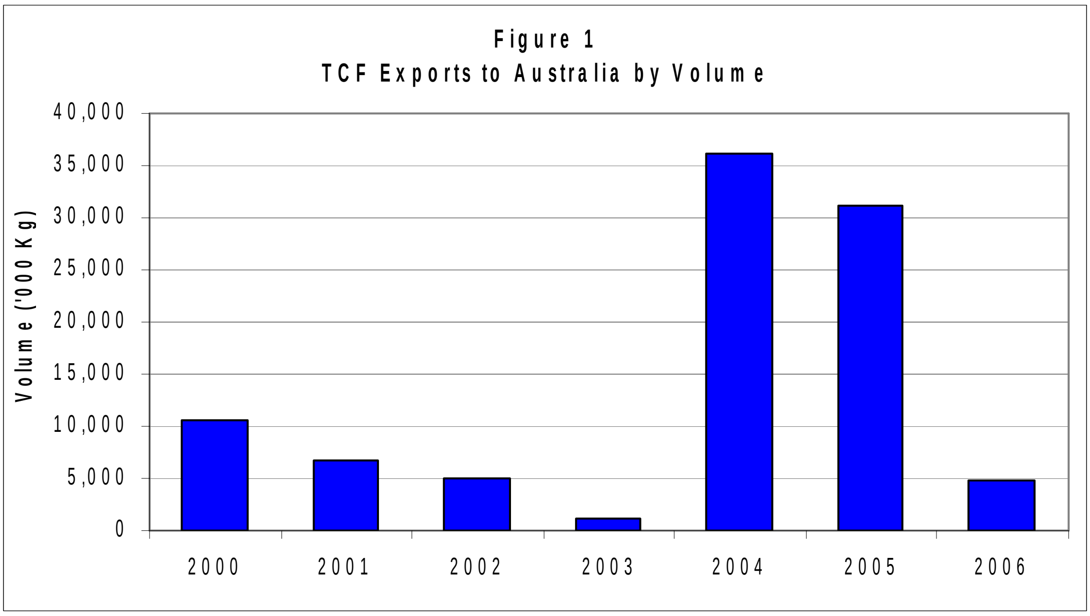
It has also become apparent that, in some circumstances, customers of Fiji manufacturers are dictating the way in which ELAC points generated by the manufacture of their commissioned product are to be used later on. Whilst it is unclear how widespread this activity is, it does appear to be contrary to the intention of S-TCF in that S-TCF is designed to assist Fiji manufacturers not their customers.

FINDINGS

A) Trade Between Fiji and Australia

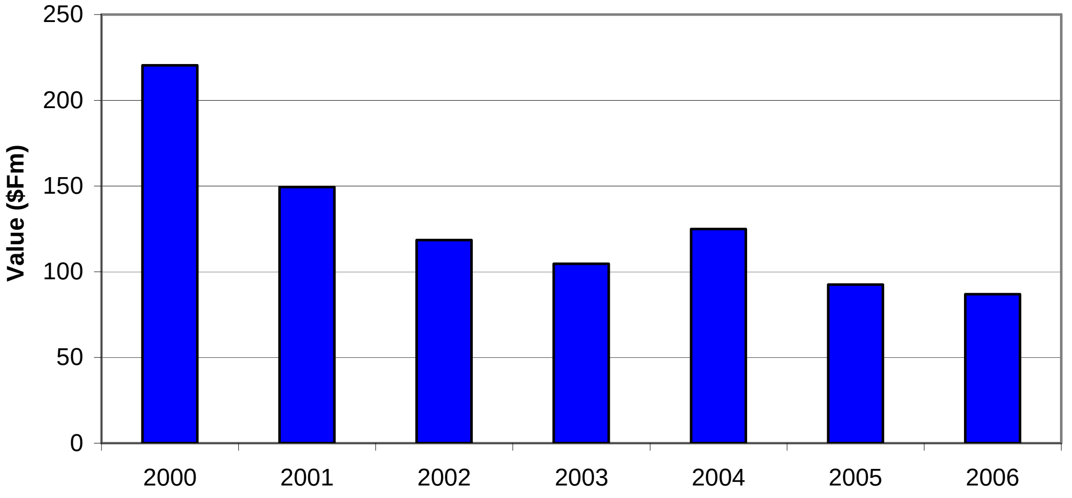
One of the key objectives of S-TCF program is to encourage trade in TCF goods between Australia and FICs and between FICs. Analysis of export statistics provided by the interim GoF indicates that since 2004 (the extension of S-TCF), exports of TCF goods from Fiji to Australia have declined in both volume and value (Figure 1 and 2 respectively). It can also be seen that since the introduction of S-TCF in 2001 until 2006, the volume of exports has decreased by 28% and that the value in exports has decreased by 42%.

However, there have been periods of significantly higher volumes of trade, notably in 2004/2005 where the volume reached 36 million kg and 31 million kg respectively, up from 1 million kg in 2003. The fact that the value of exports for 2004 and 2005 remained relatively constant indicates that, in these years, the average value of the garments exported was quite low. In 2003, for instance, the average value per kilogram of goods exported was $96. However, by 2004, this figure had dropped to $3. Such a dramatic fluctuation in export volumes also raises questions as to the accuracy of the data supplied.



Source: GoF

Figure 2
TCF Exports From Fiji to Australia by Value



Source: GoF

Nevertheless, this fluctuation in export volume may also be partially attributable to the nature of Fiji TCF sector, in that it is dependent on securing manufacturing contracts which are predominantly of a short timeframe and of low volumes. A key example of this aspect of the Fiji industry is that approximately one third of the reduction in Fiji TCF exports from 2004 to 2005 can be attributed to the decision of one customer in Australia to no longer source the majority of its products from Fiji. As these manufacturing decisions are largely made on cost, low labour cost countries are becoming an increasingly significant competitor to the Fiji TCF industry.

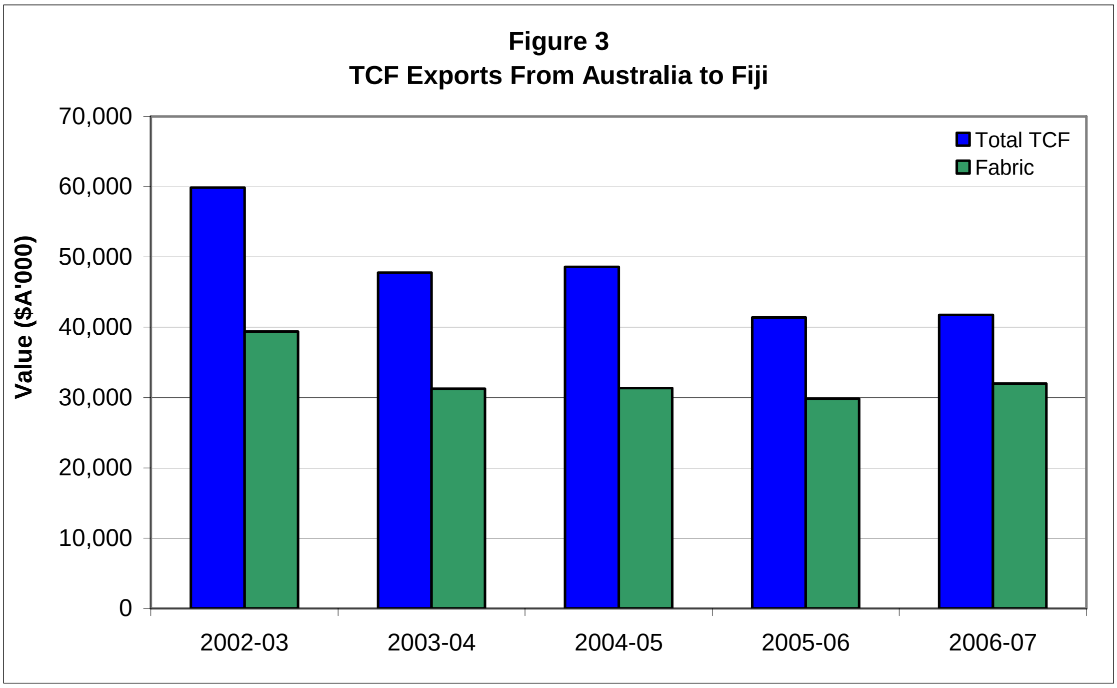
However, S-TCF does provide a cost advantage to Fiji firms in that it can reduce the cost to produce garments by using lower cost third country textiles whilst still being able to claim duty free status when the final good is imported into Australia. Through the provision of S-TCF, Fiji firms that utilise Australian fabrics increase the local content on certain garments and thus generate ELAC points. These points can then be used on other products that may substitute cheaper third country fabrics for Australian fabrics, to bring their LAC level up to the 50% needed to qualify for duty free entry into Australia. This lack of duty payable combined with the cheaper textiles can provide a cost advantage to Fiji manufacturers. In certain circumstances, this cost advantage can be significant enough to secure contracts and so it could be argued that S-TCF provides Fiji with an advantage over other lower labour cost countries.

Anecdotal evidence provided by customers of Fiji manufacturers in Australia indicates that while Fiji is unable to compete on the basis of price with low labour cost countries, such as China, Fiji's strengths lie in being able to do small batch runs of garments with a relatively short turn around time. Further reports indicate that Fiji's other main strengths in supplying to the Australian market are its physical proximity to Australia, the fact that the predominant language spoken is English and reliable and efficient transport . These strengths, combined with the cost advantage that S-TCF provides, enable the Fiji TCF industry (when supplying to the Australian market) to remain relatively competitive with emerging low labour cost competitors.

A key factor in the decision to extend S-TCF was that it does not adversely impact the Australian TCF industry. Australian fabrics have been an important component in the production of garments in Fiji and have historically made up a large proportion of TCF exports to Fiji. As can be seen in Figure 3, while TCF exports to Fiji have decreased since 2002-03, fabric exports have remained at a relatively constant level in terms of value, with the share of fabric exports increasing from 65% of all TCF exports to Fiji in 2002-03 to 77% of total TCF exports by 2006-07.

This seems to indicate that Australian fabrics continue to remain an important input into the production of garments in Fiji and that S-TCF has had little negative impact on Australian suppliers of fabric. Indeed, the fact that exports of Australian fabric to Fiji have remained constant seems to indicate that S-TCF may be responsible for maintaining a constant "pull through" of Australian fabrics in the face of increased competition from third country fabrics. Considering that some Fiji manufacturers are generating more ELAC points than they are using, it also seems to indicate that Australian raw materials, such as fabric, are continuing to be an important component in the manufacture of goods in Fiji.

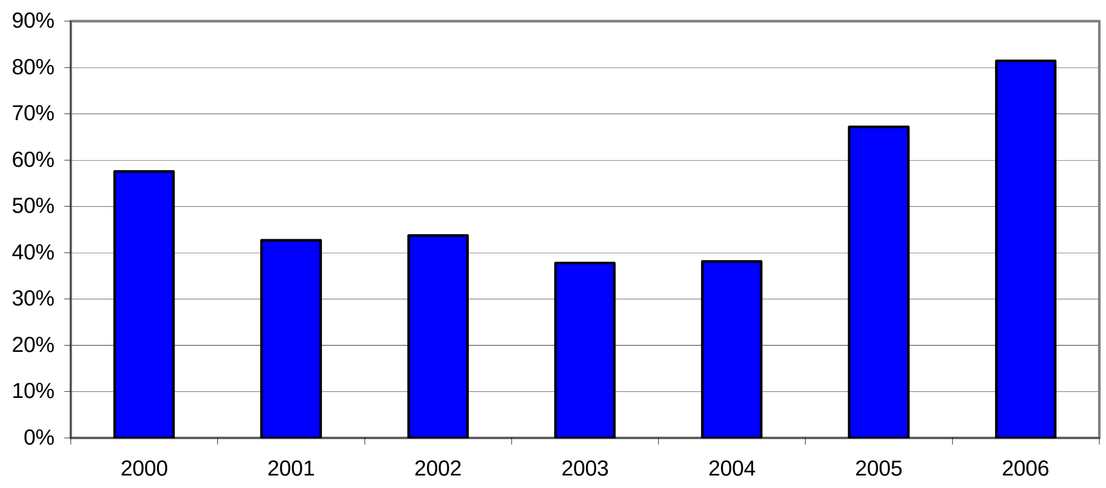
However, it is also possible that the constant level of fabric exports could be explained by the notion that Australian customers dictate which fabric they would like used in the manufacture of their garments. Nevertheless, it seems apparent that third country textiles have had very little impact on the export of Australian fabrics to Fiji.



Source: ABS

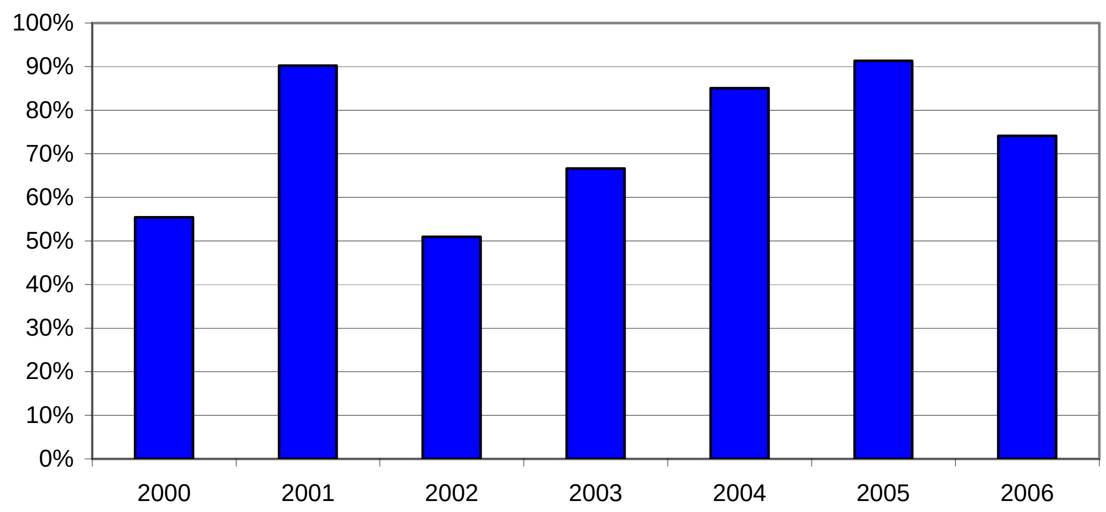
Based on the information provided by the interim GoF, it would appear that Fiji's reliance on Australia as a TCF export market is also increasing. In terms of value, Australia's share of TCF exports from Fiji has gone from 37% in 2003 to more than 80% in 2006 (Figure 4). On the other hand, Australia's share of exports by way of volume has remained relatively constant since 2003 (Figure 5). This clearly demonstrates the importance of the Australian market to the Fiji TCF industry.

Figure 4
Ratio of TCF Goods Exported From Fiji to Australia by Value



Source: GoF

Figure 5
Ratio of TCF Goods Exported from Fiji to Australia by Volume



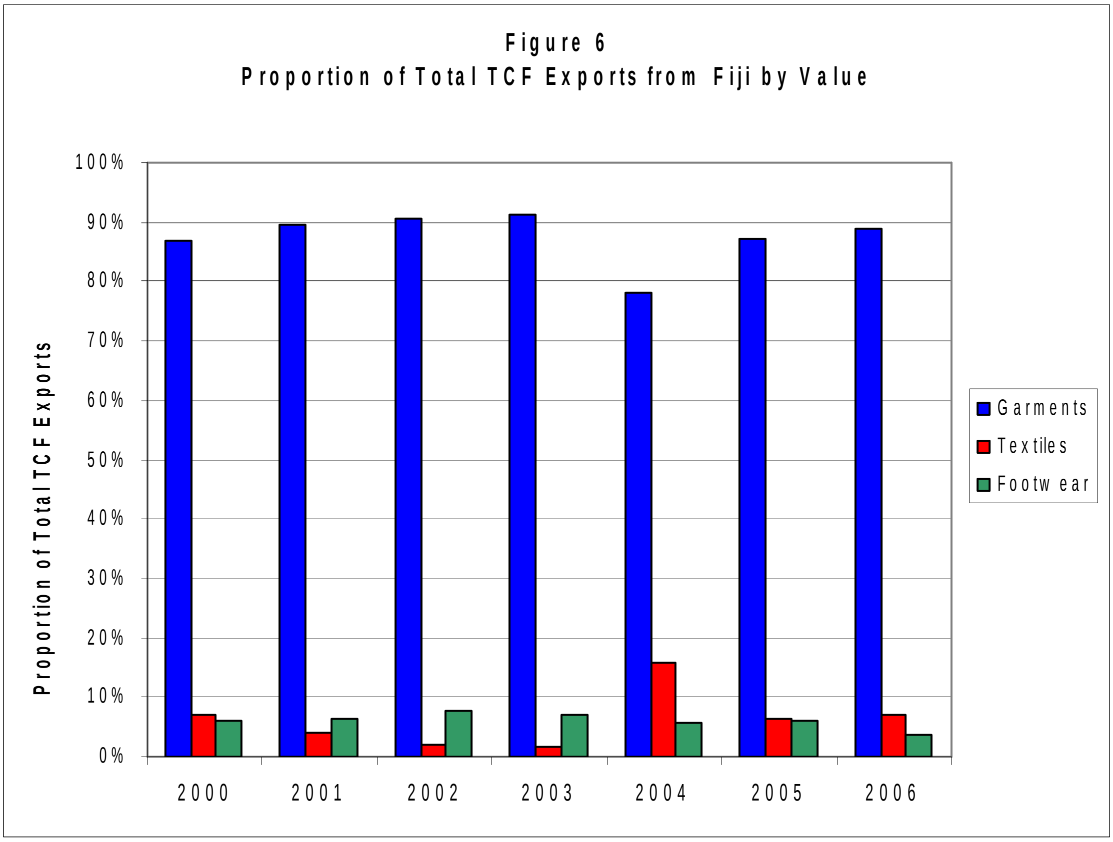
Source: GoF

B) The Diversity of TCF Manufacture in Fiji

Historically, Fiji has not had a very diversified TCF manufacturing sector and has predominantly focused on producing garments following the "cut, make and trim" (CMT) model of the industry. To ensure a secure, profitable and long term TCF industry is maintained in Fiji, the industry needs to diversify so that it can manage any changes the market may go through. A key objective of S-TCF was to encourage increased diversity in the manufacture of TCF goods.

On the basis of the information provided by the interim GoF, it appears as though the Fiji industry has diversified very little, if at all, since the introduction of S-TCF. Information as to the total types of TCF products manufactured in Fiji (both for export and Fiji's domestic market) was unavailable. Examination and analysis of participants' ELAC registers also provided little insight as to the types of products manufactured. As a result, export data provided by the interim GoF and unpublished import data supplied by the Australian Bureau of Statistics (ABS) was used in the analysis of whether any diversification had taken place in the Fiji TCF sector.

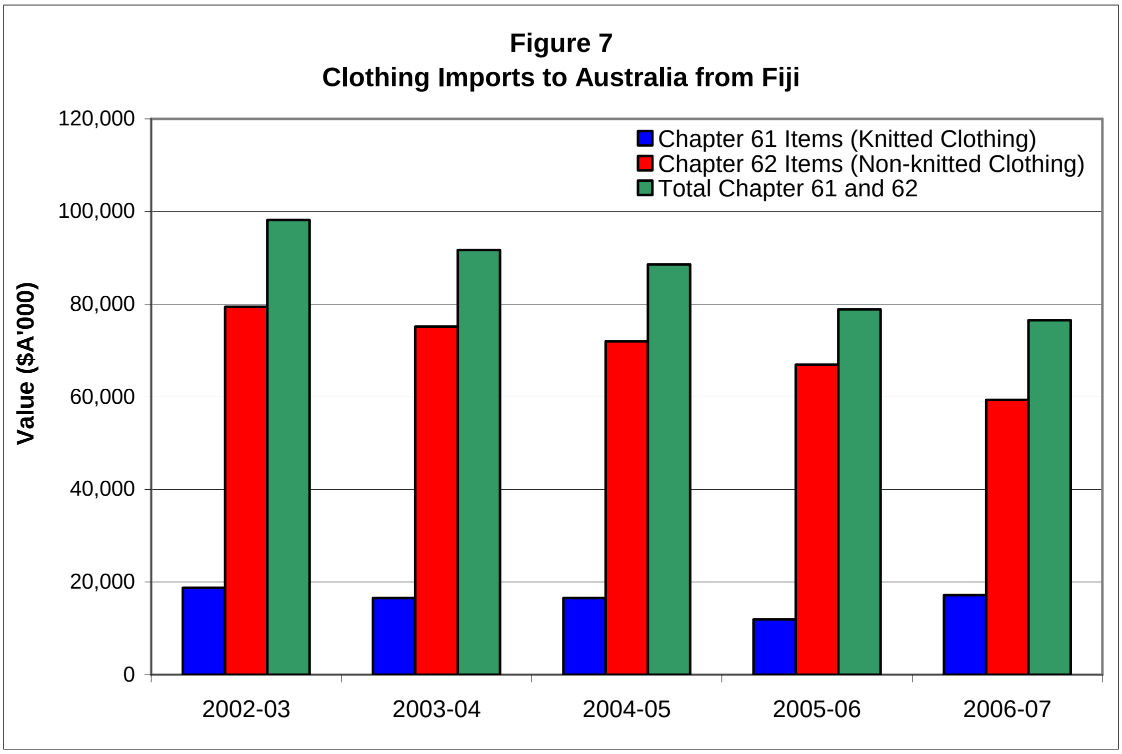
As can be seen in Figure 6, the export of garments accounted for approximately 87% of all TCF goods that were exported from Fiji in 2000 whereas by 2006 this figure had risen slightly to 89%. This figure has remained relatively constant over the period 2000 to 2006, except for 2004 where it dipped to 78% following a rise in the export of textiles, indicating that very little diversification has taken place.



Source: GoF

Analysis of ABS data confirms that the vast majority of TCF goods imported into Australia from Fiji continues to be clothing items. In 2006-07, clothing made up approximately 92% of all TCF imports into Australia from Fiji, up from 85% in 2002-03, verifying that clothing remains the dominant segment of TCF exports from Fiji.

Further analysis of the ABS data reveals that the types of clothing imported into Australia from Fiji vary very little, with the majority of clothing items imported clearly being woven garments. In fact, by 2006-07, woven garments had made up 78% of all clothing imports from Fiji, with knitted garments making up the remaining 22% (Figure 7). Further reinforcing the importance of woven garments is the fact that in 2002-03, woven garments made up 68% of all TCF imports from Fiji and by 2006-07, this share of woven garments had climbed to 71% of all TCF imports. This again supports the view that Fiji TCF continues to focus on the production of clothes, particularly woven garments.

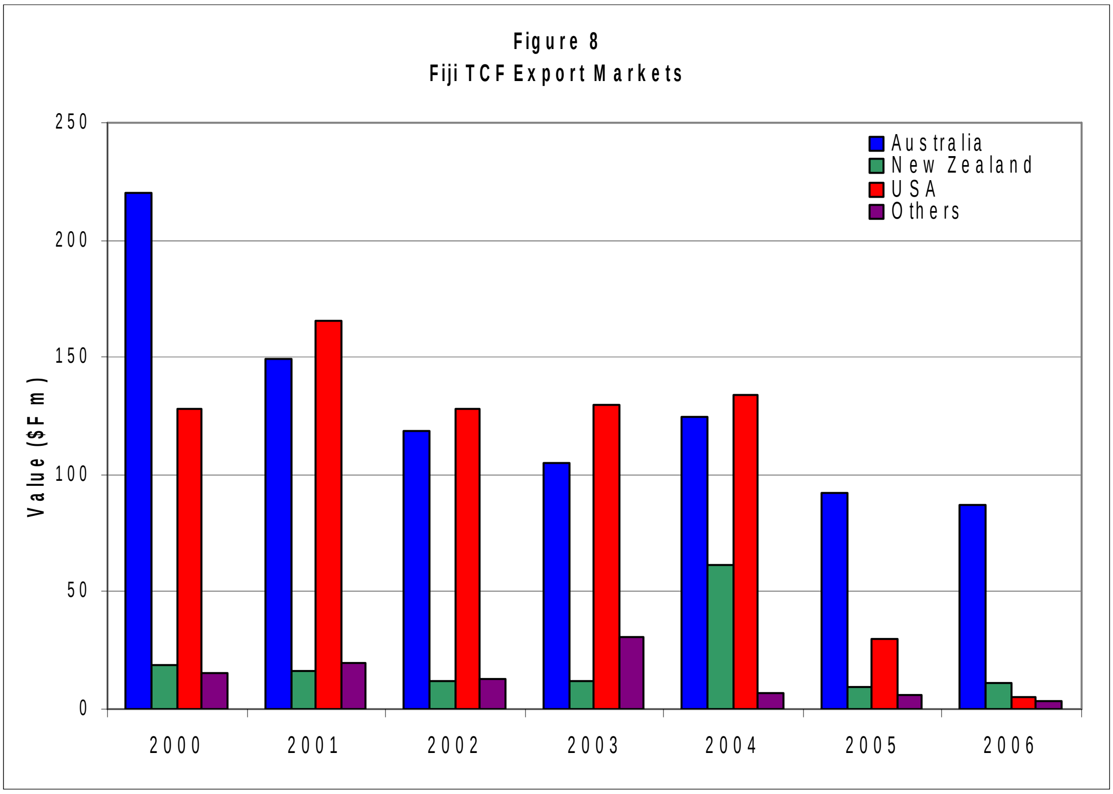


Source: ABS

Most of the manufacturers in Fiji are dependent on securing manufacturing contracts from customers in Australia who dictate the type of product they want produced, which is in turn dictated by the market in Australia. As such, it remains questionable how much impact S-TCF would have in encouraging a manufacturer in Fiji to diversify into new products if they do not have customers requesting such a product. Nevertheless, as noted by some in the industry, there is an opportunity for the Fiji industry to take the initiative and to promote its strengths and abilities so it can attract new customers who may be requiring new products but may have been unaware of Fiji's manufacturing capabilities.

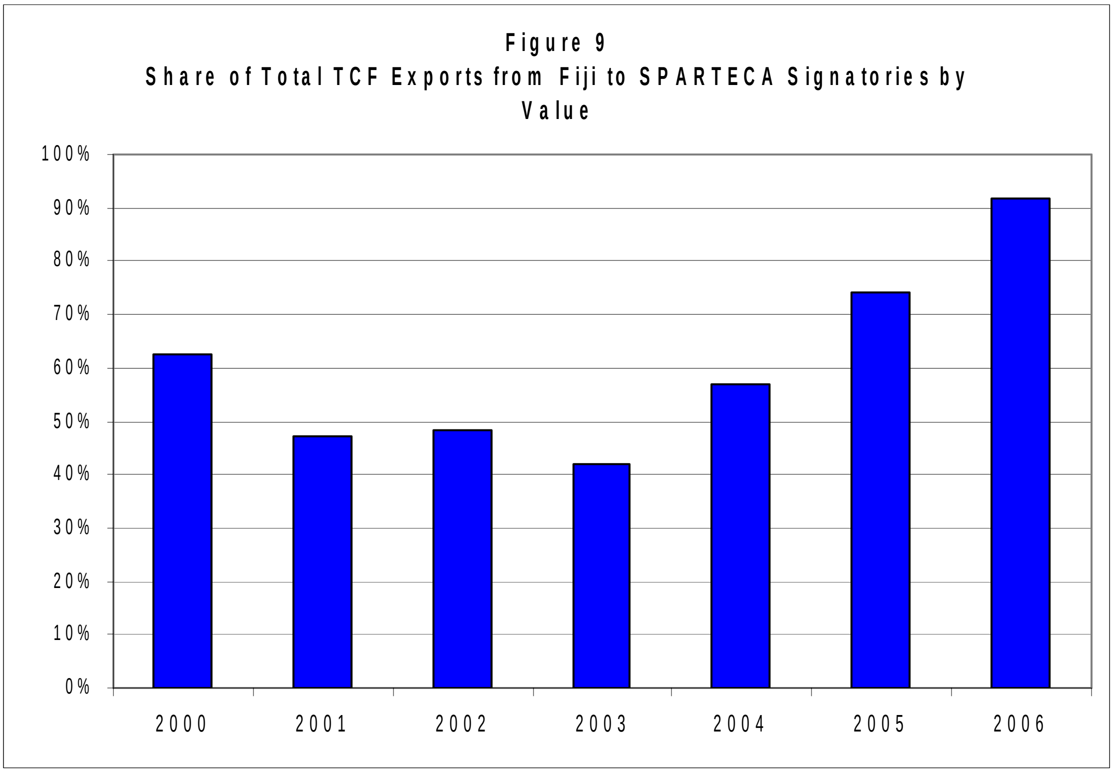
C) The marketing of TCF goods and services to markets outside the confines of SPARTECA

Historically, Australia and the United States have been the major markets for TCF goods from Fiji. However, with the removal of quotas for countries such as China by the US at the end of 2004, Fiji exports to the US fell away quite dramatically due to the increase in Chinese exports to the US, to the point that in 2006, they were only 3.7% of 2004 levels. This trade distortion is clearly illustrated in Figure 8 below, where the cessation of manufacturing in Fiji by a major US exporter in early 2005 is quite noticeable.



Source: GoF

As a result of the dramatic decline in exports to the US, the two largest markets for Fiji TCF goods are now Australia and New Zealand (both SPARTECA signatories). This would seem to be contrary to the objective of S-TCF to encourage FICs to market their goods outside of the South Pacific region. As a result of the US decline, Fiji is now even more dependent on exporting to the Australian and New Zealand markets, with these two markets representing more than 90% of Fiji's TCF exports in 2006. As can be seen from Figure 9, this dependence on Australia and New Zealand has been increasing since 2003 when SPARTECA countries made up only 42% of all TCF exports. Again, this is predominantly due to the decline in the US. However, the slight decline in growth in other markets (Figure 8) demonstrates that further encouragement may be needed for the Fiji TCF industry to promote its products to other markets.



Source: GoF

Even if S-TCF was providing support to the opening up of new markets, there appears to be a reluctance on the part of some Fiji manufacturers to engage these markets. Informal feedback received from two leading garment manufacturers revealed that both were dismissive of selling to European markets even with trade barriers minimised or removed by an agreement with the European Union. Both manufacturers noted that the shipping times and the costs involved would render them uncompetitive. It is unclear whether S-TCF has played a role in generating this reluctance or if it is just a characteristic of the industry that has developed over time.

However, it is important to note that some Fiji firms are exporting goods to markets other than the US, New Zealand and Australia. As can be seen in Figure 8, at least 3.5% of all TCF exports from Fiji in 2006 were to other markets, thereby demonstrating that some Fiji firms are able to export to other markets competitively.

Australian Government's Fiji TCF Productivity Support Program

In addition to the benefits provided by S-TCF, Australia has committed up to $3 million over 3 years through the Fiji Textile Clothing Footwear (TCF) Productivity Support Program. The Program provides technical and training support that enhances the sustainability of the Fiji TCF industry, through improvements in efficiency, productivity, product quality and market reach. It is hoped that this support package will improve the Fiji TCF industry's international competitiveness and allow it to engage other markets in the near future.

THIRD PARTY FABRICS

Options for Third Country Fabrics

As directed by the Australian Government, the mid-term review examined options for including third country fabrics as local area content under S-TCF. This issue was examined by Australian officials, with a number of options being considered based on existing trade agreements.

Further analysis of these options revealed that they would ultimately be unfeasible given the limited timeframe of S-TCF, and the fact that the administrative costs to both Fiji manufacturers and the Australian Government would not render any significant benefit to the Fiji TCF industry. Further information regarding this rationale was provided to the interim GoF and the Fiji TCF industry who subsequently agreed that any option for including third country fabrics as local area content would not be practical.

APPENDIX 1

SPARTECA (TCF PROVISIONS) SCHEME
MID-TERM REVIEW

Terms of Reference

On 8 August 2004, Australia's Prime Minister, the Hon John Howard MP, announced the extension of the SPARTECA (TCF Provisions) Scheme ("S-TCF") until 31 December 2011, with a review of the scheme's effectiveness to be carried out in 2007.

A. Accordingly—

1. The Mid-Term Review will examine the impact of S-TCF on:
    a. TCF trade between Fiji and Australia;
    b. the diversity of TCF manufacture in Fiji; and
    c. the marketing of TCF goods and services to markets outside of the confines of SPARTECA.
2. For these purposes, the Review will be limited to implementation of S-TCF Scheme as agreed by the interim Government of Fiji (GoF) and put into effect on 28 September 2006.
3. The Review will be able to draw on information provided by the interim GoF and Australian TCF manufacturers, as appropriate.

B. Following discussions with the interim GoF and industry in Australia and Fiji—

1. The Mid-Term Review will also examine options for including third country textiles as local area content.
2. For these purposes, the Review will consider any comments received from the interim GoF, Fiji and Australian TCF manufacturers on the options examined.

The Review will be undertaken by officials from the Department of Foreign Affairs and Trade, AusAID, the Department of Industry, Tourism and Resources and the Australian Customs Service.