International Journal of Business and Management Studies,
CD-ROM. ISSN: 2158-1479 :: 2(1):137–146 (2013)

LOCAL CONTENT POLICY AND THE WTO RULES OF TRADE-RELATED INVESTMENT MEASURES (TRIMS): THE PROS AND CONS

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Observers have very recently witnessed the increasing tides of local content rules adopted and applied by governments of many resource-rich developing countries. Such countries have particular concern about how they could extend the benefit potentials of their massive resources to their citizens and to every sector of their economies by boosting the local participation of the domestic firms in every stage of the resource development. This, according to their own belief will help them eliminate the resource trap they have been in for so long. The policy, according to many scholars assures more local employment, domestic market growth, enhanced local industrial base and the general economic development. From the other side of the coin, the policy is one of the specific performance requirements prohibited by the World Trade Organisation (WTO) of which most of the countries implementing it are members. This paper intends to discuss the TRIMs prohibited by WTO with particular attention to local content requirements after discussing its benefits and relevance to the developing countries. The paper will therefore conclude by expressing its position upon the justification or otherwise of using local content in the developing countries despite all the arguments against it.

Keywords: Local content, World Trade Organization, Trade-related Investment Measures, Oil and gas, Developing countries

Introduction

The renewed local economic development arguments of natural resource-rich developing countries were ignited particularly by the resource curse hypothesis. The theories of the paradox of plenty (Karl, 1997) and the resource curse (Auty, 1994 and Ross, 1999) are of the opinion that countries with total dependence on natural resources such as oil and gas become the less developed and perform significantly worse than the countries that do not have this natural abundance. Auty (1994, 1998), Davis (1999), Karl (1997), Ross (1999, 2001), de Soysa (1999), Sach and Warner (1995) and Bergensen et al (2000) are examples of studies which indicate that the swift increases in mineral resource revenues may impede economic development of a country, trigger political instability, increase social inequality and hamper smooth democratic processes. Collier (2000, 2003) argues that based on the World Bank data, indicators have shown that a country is more vulnerable to underdevelopment and massive corruption as it depends largely on one or very few commodities (particularly oil). Sachs and Warner (1995), Leite and Weidmann (1999) and Papyrakis and Gerleigh (2004) document higher rate of domestic conflicts, poverty, and bad UN Human Development score for the resource-rich developing nations. This is what has led the stakeholders in the affected countries to begin to realise that oil is more of a curse to their nations than a blessing.

Research however shows that this resource curse syndrome is not an ‘iron law’, (Auty, 1994: 12), but can be avoided through a ‘careful mineral windfall management’ (Davies, 1995: 1765). To systematically avoid the resource curse, many resource-rich developing countries adopt various policies and strategies that would help them maximize and extend the massive benefits of their extractive industries to other sectors of the economy and the entire citizens through the provision of employment and effective inter-sectoral linkages. One of the most commonly used strategies is the ‘Local Content Development Policy’. This policy has been adopted and applied by large number of governments including those of the developed economies at the period of their industrialization. The policy was later prohibited by the WTO as it forms one of the performance requirements that violated the provisions of the GATT. The following section will take a brief review of the local content as a developmental policy used by developing nations.

The Local content Policy

Generally, the work of Grossman (1981) is considered by many scholars to have provided the first and most important intuitive foundation for the academic literature in the field of local content, and also considered to have presented ‘one of the original formal models’ on ‘local content protection schemes’ (Richardson, 1993; Veloso, 2001: 32 and 2006: 748). The work studied the influence of content protection and content preference on resource allocation in relation to market structure and domestic intermediate goods industry. Although an entirely new concept, local content development becomes a recognised catch-word in the oil and gas industry, and currently attracts more academic attention and global popularity (Richardson, 1993; Kazzazi and Nouri, 2012). The concept gathers several definitions from the various understandings of scholars, commentators and industry experts. For instance, Belderbos and Sleuwaegen (1997: 103) consider local content as consisting of the requirements that companies operating in a country are to secure a given percentage of intermediate inputs locally. They further point out that local content requirements were initially applied on downstream sectors in host developing nations with the objective of promoting the intermediate input industry. Local content is also described as the quantum, percentage or proportion of inputs (labour, materials and parts) derived from the domestic economy and utilized in the production processes (Belderbos and Sleuwaegen, 1997; Barclay and Esteves, 2011; Oguine, 2011; Ofurhie, 2001) for the purpose of adding value to the local economy (INTSOK, 2003; Wells and John, 2008; Warner, 2011). Other studies that consider the economies of local content include Aharonson et al. (2007), Kwon and Chun (2009), Beghin et al., (1997), Lahiri and Ono (1998), Qui and Tao (2001), Lahiri and Mesa (2006), Li et al. (2007), Reimer (2011), Koopman et al. (2012).

Local content as a policy in the oil and gas industry was said to have originated from the North Sea early in the 1970s and took the form of import restrictions and/or the creation of national oil companies. Its major objectives were transfer of technology, provision of local job opportunities, creation of backward and forward linkages, and increase in ownership and control (Lec, 2011). Australia used local content in its automobiles and tobacco industries, Canada used the policy in its automobiles industry, and most of the European countries also applied the policy in their automobile and electronic industries (Veloso, 2006). Other countries also used the policy so extensively in their wind power industries. For example, China had in 1996 introduced local content policy which demanded 70% domestic content as at 2004, and local content had also become a pre-condition for the award of wind farm projects. The policy was later abandoned in 2009. Brazil also introduced a similar policy in its wind energy, even though the policy has little significance on the economy because of the lack of adequate capacity. A number of the Spanish provinces such as Navarra, Valencia, Galicia, Castile and Leon, have adopted and applied local content policies independently; companies that conform to the rules are compensated by given access to market. Quebec's local content policy had started in 2003, and stipulated that 60% of the expenditure spent on turbines has to be localized (Hao et al., 2010). The policy is considered to play a major role in various industries and sectors of the economies of the developing world (Moran and Pearson, 1987; Guisinger and Associates, 1985; UNCTAD, 1991 in Veloso, 2006).

Results on the roles of local content in development appear to be mixed. For this, Veloso (2006) suggested that the very little empirical evidence available shows that the economic benefits of local content are two-directional. Though the protectionist or discriminatory measures in general are found to be effective in boosting the nascent industries, enhancing the output level, and the general provision of technical competence (Wade, 1990; Singh, 1994; Amsden, 2001; Kumar, 2002; Osammor, 2008), others argue that such policies only serve particular interest of the regulators (Grossman and Helpman, 1994), that specific sector selection may distort the market (Bhagwati, 1988), and that government may select wrong sector or output to protect (Krueger, 1990). In local content situations however, domestic prices of intermediate products tend to be higher than the international prices due to inferior technology (Grossman, 1981; Lahiri and Ono, 2003). Oladele (2001), Olorunfemi (2001), Ogiemwonyi (2001), Aneke (2002), Per Heum, et al. (2003), INTSOK (2003), and Shirley (2005) are some of the studies that claim that the policy has little success in some resource endowed countries. In Lec (2011: 21)'s opinion, local content is a 'trade-off between short term efficiency and long term economic development'.

The Trade-Related Investment Measures (TRIMs)

There are various purposes why policy-makers adopt performance requirements particularly in the natural resource sectors. Generally, the essence of the requirements is to tackle policy or market failures unique to developing economies (DiCaprio and Gallagher, 2006). These failures are the products of underdeveloped human, product and capital market capacities (Stiglitz, 1989) as a result of which the local industries of these countries cannot favourably compete in an open space without government intervention through various forms of protection (DiCaprio and Gallagher, 2006). Notable objectives for applying the performance requirements include but not limited to fostering the local capacity and value added by enhancing domestic industrial base, employment generation, innovation, promoting linkages, production efficiency, and technology transfer (UNCTAD, 2003; DiCaprio and Gallagher, 2006: 784).

According to Lall and Theubal (1998) developing countries often adopt two different strategies to tackle their market failures. These include either the adoption of 'horizontal' or 'selective' interventions. By horizontal intervention, developing countries attempt to subsidize such things as training and skills acquisition, research and development, etc in their infant industries. This will mitigate the gravity of the market failures. On the other hand, the aim of the selective intervention, which is the second strategy, is to properly control foreign direct investment (FDI) by strategically selecting and supporting a particular sector to enable it develop to stand on its own.

According to UNCTAD (2007), Trade-Related Investment Measures (TRIMs) generally incorporate wide classes of different performance requirements and other incentives which countries impose on investors. Large number of countries around the world have utilized performance requirements to achieve maximum benefits from foreign direct investment (FDI). Local content which is a subset of these requirements was used as a medium for local job creation, local training and development, technology transfer, and as a check against trade imbalances.

Foreign investors do not favour the use of performance requirements as they look at them as an interruption in their investments. This pressure had necessitated the US government to include the performance requirement issue on the 1982 GATT's ministerial meeting agenda. Many developing countries had opposed to this view. Eventually, the outcomes indicated that some trade-related investment measures had been prohibited. The prohibited measures include local content and trade balancing requirements as they violate art. III of GATT (national treatment). Import restrictions, foreign exchange balancing, and domestic sales violate art. XI of GATT and therefore prohibited as well. For this purpose, Warner (2011) argues that local content policies if they would mandate the use or purchase by a firm of output from a local source, be it in terms of a specific output, volume or value are clearly prohibited.

The WTO Trade-Related Investment Measures (TRIMS) of 1995 therefore required countries to do away with certain forms of performance requirements within a given period (Gu and Yabuuchi, 2003) effective from 1st Jan, 1997 in the case of the developed nations, 1st Jan., 2000 for developing nations, and 1st Jan., 2002 for the least developed nations. Malaysia, Argentina, Columbia, Mexico, Thailand and Pakistan are six developing countries, to which extensions were granted to December, 2003, while Romania extended to May, 2003 and Philippines extended to June, 2003 under Article 5 of the agreement (UNCTAD, 2003). Belderbos et al. (2002) observes that the developing countries were already committed to a phase elimination of performance requirements. Non-WTO member countries are seen to be widely using various forms of performance requirements (including local content) as an efficient policy to develop their local capacity (Gu and Yabuuchi, 2003).

The advanced countries also use the rules of origin, which works in a similar way as the local content rules, such as the NAFTA and EU (Takechi and Kiyono, 2003). The EU antidumping legislation clearly incorporates local content requirements (Bronckers, 1995). Jie-A-Joen, et al (2002) also noted that Japanese firms have faced a 70% local content from the UK government at one time despite the Uruguay Round that initiated the prohibition of performance requirements. For this, Enderwick (2011: 331) wonders why some developed countries that advocate globalization the most are currently 'at the forefront of embracing protectionism'. This is also evident in some US trade agreements with Peru and Panama, where trade measures where used to enforce labour standards. The following table show a little example of the countries that used or are still using and benefitting from the policy.

Countries that applied or are still applying the local content policy in their oil and gas sectors

Country	**Legislation/Policy**	**Year enacted**	**Focus**
UK	Policy	1970	In-country procurement
Norway	Local content Law (Article 54 of the Royal Decree of 1952)	1972	Indigenous participation
Malaysia	Petroleum Development Act	1974	Licensing
Brazil	Local Content Legislation	2003	Oil concession
Trinidad & Tobago	Local Content & Local Participation Framework	2004	In-country fabrication
Kazakhstan	Law of the Republic of Kazakhstan 223-IV	2009	Procurement & services
Indonesia	Local Content Rules	2009	Procurement of domestic inputs
Nigeria	Local Content Act	2010	Indigenous participation and

			domiciliation of oil and gas activities

Compiled from Klueh et al (2011) and BSR (2011)

Arguments in Favour of Protectionism

Most developing economies especially the mineral rich often argue in favour of applying the performance requirements especially local content in their oil and gas industries for its immense benefits discussed above. Their major line of argument is the fact that since historically most of the developed countries had used these requirements while they were trying to develop their industries. Others are based on the infant industry, market power, social compensation, political harmony and strategic sectors arguments. These arguments will be presented one after the other.

The Infant industry argument

First coined by Alexander Hamilton, a US Secretary for the Treasury in 1791, and later developed by Friedrick List (Melitz, 2005), infant industry argument is of the opinion that the emerging domestic industries which experience external dynamic learning effects, unlike their international counterparts that are mature and produce a commodity which is not a perfect substitute for the domestic product, are obviously lacking the economies of scale advantage, hence, the need to be protected and supported up to the period they can effectively compete with them (Melitz, 2005; Warner, 2011). Infant industry argument is regarded as the most important and one of the oldest justifications of protectionism used to protect nascent industries in host countries (Melitz, 2005; Enderwick, 2011). The underlying idea of this argument is that for any nation especially the developing ones to set up a new industry, the pioneer industry may need to be sheltered from foreign competition to the time it can depend on itself. It is assumed that infant industries lack the ability to compete unassisted with international competitors that enjoy an 'unfair competitive advantage' in many forms (Enderwick, 2011: 330). This argument had historically been used by the United States when it was trying to industrialize its economy amidst the British dominance of the global trade. The US was therefore being branded 'the motherland of infant industry protection' (Shafaeddin, 2000: 4). Very recently, the argument was also used by South Korea and Japan in their attempt to face global competition (Enderwick, 2011). This is a clear justification for the use of local content for development.

The Market Power Argument

Ordinarily, international suppliers may be found to be unduly applying market power to compete with local industries. Market power here implies foreign suppliers' purchasing powers which make the local firms to be at disadvantage. Warner (2011) argues that market power argument is different from the infant industry argument in that under the latter domestic firms will be at advantage from the local content specifications; whereas under the former, local content requirements are not intended to advantage the local industry but are used to make sure that the domestic industry is not at disadvantage.

Social Compensation Argument

Protectionism particularly through local content rules can also be justified based on its social impact. The nature of oil and gas operations is always accompanied with social and ecological disasters (Ogri, 2001). This has to be fairly compensated (Warner, 2011). The major idea behind this argument is that oil communities that have been negatively affected by oil operations should get reasonable benefit in return. This can be made possible through adopting policies of local content that are capable of influencing job creation and value addition for the local communities. By implication, this is a real case of community content which Oguine (2011) describes as the level of contracts or jobs created by the oil companies to the immediate communities. This is another reason why local content initiative could be seen as an extension to corporate social responsibility (CSR).

The Political Harmony Argument

Local content policies may also be used as an instrument to achieve several political objectives. Political harmony can be described as the government objectives to align its interest with that of the society. Local content rules are in use and succeeding in Nigeria for example, to prevent conflict and crises especially within the oil producing communities. In Liberia and Sierra Leon the rules were used to achieve post-conflict harmony (Warner, 2011). If very well utilized, mineral resource benefits have the potential of promoting peaceful co-existence among communities, resolving armed conflicts, as well as conflict reoccurrence (Wennmann, 2012).

Strategic Sectors Argument

Due to the increase in security consciousness, Enderwick (2011) also identifies justification for protectionism in some sectors categorised as ‘strategic’. Sensitive sectors such as energy, communication and transport, are presently subjected to some ownership restrictions because of their strategic importance. Economic excellence in these sectors may not be guaranteed without one form of protectionism or the other.

Conclusion

The presence of the resource curse and market failure, and the urgent need to eliminate them by the concerned governments are real according to what is available in the literature. It has been shown that developing countries often adopt either the horizontal or the selective intervention to check and correct their economic mishaps. One of the most common strategies is the local content policy which had been widely adopted by developed nations in their industrialization processes and presently applying it in various guises. Although there are varied opinions about the economic effectiveness of the policy, it is still believed by many governments of being capable of stimulating job opportunities, value addition, and industrial base, among others. Unfortunately, the policy appeared to be one of the performance requirements said to be in violation of the provisions of GATT and therefore prohibited. Why did this prohibition only come after the policy benefits had long ago been exhausted by many developed countries? This question needs an answer. Is it because their industries have developed enough and do not need protection anymore? This may possibly be the answer. Having realised this facts resource rich developing countries stick to the application of this rule to develop their own economies the way the others had done. These countries depend their actions largely on a number of arguments such as the infant industry argument which originated from the UK and the US where it has even been argued that at a point of time the US was even branded the 'motherland of infant industry protection'. Other arguments include the social compensation arguments which tries to justify the use of the rule to compensate the resource communities for the negative impacts from resource operations they suffer; the political harmony argument, which used the policy as a medium of reconciling conflicting resource communities; the market power argument, which justifies the use of the policy to protect weak and disadvantaged industries in the global competition, and finally the strategic sectors argument which is trying to secure economically sensitive sectors.

As a matter of fact, the above are strong justifications, and it is the opinion of this study that developing countries should be allowed to have their own turn. And also for the fact that the rule of origin (which works in a similar way as local content) is still in use in some developed countries.

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