

**MULTILATERAL TRADE
NEGOTIATIONS
THE URUGUAY ROUND**

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Investment Measures

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The following communication, dated 5 February 1988, has been received from the delegation of the United States with the request that it be circulated to members of the Group.

EXPORT REQUIREMENTS

I. Description

Export requirements typically oblige an investor to export a fixed percentage of production, a minimum quantity or value of goods, or (like a trade-balancing requirement) some proportion of the investment's import balance.

II. Illustrative Examples

1. A foreign investor in the machine tools sector seeks to establish a local production facility in order to avoid import tariffs. The investor, who had intended to export 5-10% of the final product, is informed by the host country screening agency that at least 25% of the final product will have to be exported if the investment project is to qualify for limited fiscal incentives. If the investor agrees to export 50% of the final product, the government will award a full tax holiday for the first five years of the life of the investment.

2. An established foreign-controlled enterprise operating in the food processing and packaging sector is encouraged by the success of local sales. Consequently, the firm wishes to construct a second facility in order to expand production by 50%. The investor intends to export one-fourth of the additional production. The enterprise is informed by the host government that the project will be approved provided that half of the additional output is exported.

III. Implications

Export requirements can artificially increase the supply of affected products from the host country on world markets. This occurs because the investor is acting according to government fiat rather than responding to market conditions.

When export requirements are combined with incentives or other measures to offset increased costs to the investor, they can displace or restrict more efficient home or third-country products. For example, an investor may cancel or put on hold a planned facility in a third country. In this sense export requirements can have effects similar to subsidies. If the investor is forced to meet such requirements by exporting a product that is not competitive on foreign markets, the investor may resort to non-commercial behavior, such as dumping.

LOCAL CONTENT REQUIREMENTS

I. Description

Local content requirements typically oblige an investor to produce or purchase from local sources some percentage or absolute amount of the value of the investor's production.

These measures are essentially the same as local sourcing or import substitution requirements as the investor is obliged in both cases to source inputs locally rather than import. The required percentage or amount of local content may vary during the life of the investment. These measures appear in a variety of sectors, but they seem to be applied with greatest frequency to investment in informatics and motor parts and vehicles. As is the case with many other TRIMs, local content requirements may be accompanied by incentives.

II. Illustrative Example

A foreign investor wishes to form a joint venture to produce automobiles, some of which will be sold on the local market and others exported. The screening agency in the host country informs the investor that, whatever the price of imported inputs, during the first five years of the investment, 25% of the value of each automobile will have to come from inputs produced in the host country. After five years this figure will change to 35% unless the investor exports at least 75% of the final product, in which case the 25% local content requirement will remain unchanged for the life of the investment.

III. Implications

If an investor is a profit maximizer, he will choose to source his factor inputs according to price (i.e. least cost) and quality. Local content requirements oblige the investor to source inputs locally regardless of their price or quality competitiveness. Thus the exports of home and third countries (both DCs and LDCs) which may best fulfill the investor's needs are arbitrarily displaced by local inputs, and the investor is forced to make a sacrifice in terms of price or quality. The investor may also find that locally sourced inputs make the final product uncompetitive on international markets, and diminish returns on investment.

Local content requirements can also be costly for the host country. By artificially reducing demand for imports, these measures protect import-competing industries by insulating them from foreign competition. This protection weakens the incentive for import-competing industries to produce at competitive prices; consequently, domestic prices tend to rise and products embodying protected inputs become less competitive on export and import-competing markets.

TRADE BALANCING REQUIREMENTS

I. Description

Trade balancing requirements typically restrict an investor from importing more than an equivalent amount or some proportion of exports. The investor may be obliged to earn through exports all foreign exchange necessary for the purchase of imported goods or components. The imposition of such measures may be motivated by a desire on the part of the host country to eliminate balance-of-payments costs associated with a foreign investment.

II. Illustrative Examples

A foreign investor intends to produce tractors solely for the host country's domestic market. The investor intends to construct the engines in the host country and to import transmission systems from the home country; a variety of components would be imported from third countries.

The host government informs the investor that, for balance-of-payments reasons, the investment proposal will be approved only if all imported components are paid for by foreign exchange generated through export sales. The investor is concerned that the firm may fail to meet export targets, especially during the early years of the investment, and would be unable to import necessary components. This would complicate planning and could lead to serious bottlenecks in the production process. In order to guarantee a supply of necessary inputs, the investor informs several foreign suppliers that they will have to set up a production facility in the host country or risk losing their contract.

III. Implications

Trade balancing requirements can have restrictive effects on both imports and exports. The most immediate effect is the ceiling on imports into the host country which is determined by export performance. Imports into the host country and exports from the home and third countries may be further reduced if, as in the above example, the investor persuades foreign suppliers to establish production facilities in the host country. Exports from the host country may fall if the investor is compelled by trade balancing constraints to use costly or lower quality local inputs resulting in a final product that is not competitive on international markets.

The requirement to balance imports with exports could also lead an investor to expand exports artificially and lead to dumping.

The economic welfare costs of such measures to the host country may be similar to those associated with import quotas if the investor chooses to substitute more costly local inputs rather than import.

TECHNOLOGY TRANSFER AND LICENSING REQUIREMENTS

I. Description

Technology transfer requirements typically oblige the foreign investor to adopt production or processing techniques that incorporate more advanced or different kinds of technology than the firm would otherwise transfer.

Technology transfer often takes place via a licensing requirement, whereby the investor is compelled to permit the production, use or sale of a designated product or technology. The license typically specifies terms (such as royalty ceilings, R & D requirements, local content, etc.) to ensure that technology is transferred at costs acceptable to the host country.

II. Illustrative Examples

1. A foreign investor in the informatics sector is interested in producing a line of mini-computers for local sale and export. The investor is informed by the host government that, as a condition for entry, the firm will have to transfer the technology for making high-speed circuits to be incorporated into the final product. In addition, the firm will be required to develop compatible software applications, and to conduct a specified minimum amount of R & D in the host country during the life of the investment.

2. A potential foreign investor in the chemicals industry wishes to establish a subsidiary to produce industrial solvents used in waste disposal. The investor plans to import certain specialized chemicals and to source others locally. The host country screening agency expresses concern about the level of imports that may be necessary but approves the proposal provided that the investor agree to license his technology for certain agricultural fertilizers to a state-owned company. The investor is reluctant to do so since the requested technology is unrelated to the proposed project, and, more importantly, because the investor already produces in a neighboring country a line of fertilizers for local sale and export.

III. Implications

Technology transfer and licensing requirements may distort trade flows if the investor is obliged to produce certain inputs or final products locally rather than import.

If the transfer is not accompanied by adequate intellectual property protection, the technology may be widely diffused, leading to commercially unjustified manufacturing levels and reduced market opportunities in the host country for goods produced abroad.

If the technology is provided at an artificially low price (in effect an export subsidy), this may lead to exports that are unfairly competitive.

DOMESTIC SALES REQUIREMENTS

I. Description

Domestic sales requirements generally oblige an investor to sell a certain percentage or value of production to local establishments, usually at prices lower than those on world markets. A host government employs such measures as a way to ensure that certain products are available in sufficient quantity and at appropriate prices for the needs of local entities.

II. Illustrative Examples

A foreign investor in the mining sector wishes to develop an already existing copper mine. The host country government requires as a condition of entry that the investor enter into a production-sharing arrangement whereby the investor will supply 50% of the extracted ore to a state-owned corporation at preferential prices. The state-owned firm processes the ore, selling most of the final product on foreign markets.

III. Implications

Domestic sales requirements may initially result in a smaller volume of exports than desired by the foreign investor. These measures can also artificially reduce imports--an import-substitution effect--and serve as a means to subsidize local production.

If, as in the above example, the product is sold at lower-than-market prices to a state-owned firm, the investor subsidizes the purchases of that firm and indirectly subsidizes its exports to world markets. This process disrupts trade flows which might otherwise be determined by market forces. The trade disruption can be measured by the extent of the forced sales, and the difference between the price at which the product is sold internally and the global market price.

From the point of view of the investor, forced sales to firms in the host country at below market prices diminish potential profits. The investor may attempt to recover this shortfall through higher priced, less competitive exports. Alternatively, the investor may choose to absorb as a loss the shortfall in revenue from domestic sales; this, however, would tend to lower the rate of return on investment. If potential capital importers are deterred by these conditions and decline to invest, the host country may suffer adverse consequences for its global competitive position.

INVESTMENT INCENTIVES

I. Description

Investment incentives are government measures designed to influence an investment by increasing the profit accruing to it or decreasing the risks attached to it. These measures come in a great variety of forms including tax relief, financial inducements (such as grants or preferential access to local funding) and non-financial contributions (such as the provision of real estate). Investment incentives are often used in conjunction with other TRIMs in order to offset the costs of these measures.

II. Illustrative Examples

1. As compensation for locating in a depressed region of the host country and agreeing to a 50% local content requirement, an investor in a plant that assembles computer modems is granted a tax holiday for the first five years of the investment.

2. In return for agreeing to export 50% of its production of word processors, a foreign investor is given preferential access to import licenses for microprocessors used in fabricating the word processors.

3. Upon agreeing to export 90% of production, an investor is awarded a cash grant to defray 30% of its start-up expenses in an automobile tire factory.

III. Implications

Incentives may distort investment and trade flows, especially when they are attached to other trade restricting or distorting measures. When used in isolation, incentives have essentially the same effects as general production subsidies. When used in conjunction with measures designed to increase exports, incentives have effects similar to export subsidies; they may artificially increase export levels and lead to dumping overseas and/or shortages within the host country. Incentives may also displace sourcing from and incremental exports from home and third countries.

Investment incentives can be expensive for the host country. Host governments often forego considerable tax revenue in offering incentives. The costs of incentives are especially high when there is competition among host countries to attract foreign investors. Finally, when incentives are combined with other TRIMs, one must add the costs of incentives to the welfare costs associated with these other measures (for example, the quota-like effects of local content requirements).

REMITTANCE AND OTHER EXCHANGE RESTRICTIONS

I. Description

Exchange restrictions generally place limits on access to foreign exchange, which foreign investors may seek for a variety of purposes (import purchases, remittance of profits, dividends, etc.). Remittance restrictions, an important form of exchange control, typically place limits on the ability of foreign investors to remit profits, dividends, capital and other funds associated with investments. Another important exchange-restricting mechanism is an explicit trade-balancing requirement.

II. Illustrative Examples

1. A foreign investor would like to establish a joint venture to produce road construction machinery for the local market and several neighboring countries. The host country government informs the investor that, as a condition for equity investment, (a) the transfer of profits will be limited to 20 percent of the capital base a year; (b) the total amount of repatriated capital may not exceed the net value of the foreign investment (for example, the investor could repatriate profits at the maximum 20% annual rate for no more than five years); and (c) profit or dividend remittances as well as capital repatriations are subject to a 20% withholding tax.

2. A foreign investor wishes to create a subsidiary to manufacture agricultural machinery for which he will need to import various components. The investor is informed by the host country review board that, because of deficits in the balance of payments, half of the proposed firm's annual foreign exchange needs will have to be covered by export sales. The investor is also informed that profits may be remitted at a maximum annual rate of 15% of imported equity capital, and investment capital may be repatriated over not less than 3 years beginning 2 years after the initial investment.

III. Implications

If a firm is not permitted by the host country to remit to the degree that it wishes, funds that could be used more efficiently elsewhere in ways that stimulate trade are bottled up in the host country. This in turn can create an artificial increase in demand for local goods over imports as the firm seeks to make use of available capital that cannot be remitted.

Some exchange restrictions, especially those that function as trade-balancing requirements, have effects on imports similar to quotas.

If access to foreign exchange is partly or wholly dependant on export performance, the investor may artificially increase exports and, in difficult circumstances, be induced to dump exports.

MANUFACTURING REQUIREMENTS AND LIMITATIONS

I. Description

1. Manufacturing requirements typically oblige an investor to produce a component, product or product line that the investor may not have originally intended to produce in the host country. As a part of such a requirement, the investor may be prohibited from importing like or similar products. As an incentive, the host country may reserve part of the local market for the investor.

2. Manufacturing limitations generally prohibit an investor from producing certain goods. Often the designated goods have been reserved for local manufacturers.

II. Illustrative Examples

1. A foreign investor wishes to establish a subsidiary in the pharmaceuticals sector. As a condition for entry and establishment, the investor must agree to produce in the host country a line of low-cost, generic pharmaceutical consumer goods for sale on the local market. In return, the host country will subject competing foreign products to an import necessity requirement.

2. The host country screening agency informs a foreign investor that a number of conditions apply to direct investment in the high technology sector of a large and potentially lucrative market: (a) foreign investors may not manufacture or import products that are within the actual or potential production capability of national firms; (b) foreign investors shall not be allowed to enter into licensing arrangements for the manufacture of products in this sector that are functionally equivalent to those manufactured by national firms; (c) foreign firms in this sector are not eligible for tax and financial incentives accorded to national firms for the expansion of domestic products in this sector.

III. Implications

Both manufacturing requirements and limitations can have effects similar to import quotas, especially, as is often the case, when accompanied by measures that reserve part or all of the local market to the investor or national firms. In these circumstances, imports from home and third countries are likely to be displaced.

If a manufacturing limitation is imposed on an already established foreign enterprise that imports components used in manufacturing the affected product, those imports will no longer be permitted.

If a firm is obliged to manufacture a product for a local market of insufficient size to permit economies of scale, the firm may be induced to export that product when it would not have otherwise have done so.

PRODUCT MANDATE REQUIREMENTS

I. Description

A product mandate requirement typically obliges the investor to earmark a product for export to a specified country or region, or, more generally, to the world market. These measures have characteristics and effects similar to export requirements.

II. Illustrative Examples

1. A prospective foreign investor in the automobile sector wishes to set up a factory to produce light trucks for the local market. The host country screening agency indicates that the proposal will be approved provided that the investor agrees to produce, in addition to light trucks, a designated line of passenger cars for export to a large neighboring country.

2. An already established foreign enterprise in the manufacturing sector wishes to expand and diversify its production. The firm, which has considerable experience and expertise in the production of specialized electronics goods, plans to jump into the market for micro-chips. The host government is willing to allow the firm to create a new subsidiary for this purpose, provided that 50% of the final product is exported to a designated region.

III. Implications

Product mandate requirements can distort trade by obliging investors to export according to government fiat rather than market conditions. Depending on the terms of the mandate, the additional level of exports from the host country could be large enough in volume to displace exports from the home and third countries.

If the product mandate obliges the investor to export to a country or region that cannot absorb the product at the mandated volume, the investor may be induced to resort to dumping to fulfill the terms of the requirement.

LOCAL EQUITY REQUIREMENTS

I. Description

Local equity requirements typically specify that a certain percentage of the equity of a company created by foreign investment be held or controlled by local investors. Alternatively, such measures may establish a ceiling on foreign equity.

The share of equity designated for local investors may increase over the life of the investment, and there may be restrictions on the form in which foreign equity is held (for example, the foreign investor may or may not be allowed to count a contribution of technology towards equity share).

Local equity requirements may be softened in return for commitments by the foreign investor to, for example, increase exports or undertake local research and development.

II. Illustrative Examples

1. A prospective foreign investor wishes to set up a company to produce industrial machinery. The host country screening agency informs the investor that, as a condition for entry, the investor will have to form a joint venture with a local enterprise. At least 40% of the joint venture's equity must be held by local investors. After 5 years, local investors must hold at least 51% of the equity.

2. A prospective foreign investor in the pharmaceuticals sector wishes to set up a joint venture, retaining majority ownership for reasons of quality control. After prolonged negotiations, the host country screening agency, which normally allows a maximum of 49% foreign equity ownership, agrees to make an exception in this case due to the strong international reputation of the firm and its products. There are trade-offs for the investor as well who will be required to transfer some valuable technology and shift some of its R and D activities to the host country.

III. Implications

Local equity requirements may impose a burden on investors who seek to assure effective decision making, protect proprietary technology, control product quality or avoid raising capital in relatively inefficient capital markets. In these circumstances, investors may decide to forego an investment, locate elsewhere or not produce certain products in the host country that they would have in the absence of local equity requirements, thereby changing investment and trade flows. When tied to other measures, such as an obligations to export, local equity requirements distort trade and investment even more.