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**Indonesia's Local Content Requirements:  
An Assessment on Consistency with Free Trade  
Agreement Commitments\***

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**Abstract:** *Local content requirements (LCRs) are one of several economic instruments used by governments to protect infant domestic industries or to generate employment. Indonesia has LCR policies in several sectors. However, LCRs are often inconsistent with a country's World Trade Organization commitments. Additionally, free trade agreements could also have provisions that regulate LCRs. This paper assesses whether Indonesia's free trade agreements have provisions on LCRs, and whether its regulations are consistent with them.*

**Keywords:** Local Content Requirements, WTO, FTA, East Asia, Indonesia

**JEL Classification:** F1, F13, F15

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\* The view expressed here are authors and do not represent any of the WTO Secretariat or Member Countries, or ERIA.

## **1. Introduction**

International trade today enjoys very low tariffs following the success of the multilateral trading system. Additionally, the global economy is also supported by free trade agreements, and trends suggest that countries are active in signing them. The World Trade Organization (WTO) has recorded 350 active regional trade agreements as of 15 October 2021, compared to 1995, when the number was just 57 (WTO, 2021).

As tariffs are low, governments resort to non-tariff measures (NTMs) to protect domestic industry. There are many types of NTMs, such as customs procedures, application of certain standards, subsidies, quantitative restrictions, and local content requirements (LCRs). It is important to note that not all NTMs are bad; many have legitimate objectives, such as protecting human life, safety, and health, or protecting the environment. However, NTMs can be crafted in a way to be a disguised restriction or to constitute an arbitrary and unjustifiable discrimination. In these cases, NTMs not only disturb international trade, but also potentially negatively impact consumers.

Following the Great Recession in 2008, LCRs began regaining popularity. Governments normally adopt LCR policies with the objective to create jobs instantly at home or to nurture infant industries. However, in most cases, LCRs actually reduce efficiency and could be inconsistent with a country's commitments in trade agreements. LCRs are not a new policy for Indonesia; in the 1990s, it introduced the 'National Car Programme' through some laws and regulations. These measures were challenged at the WTO in 1996, which found some inconsistencies with Indonesia's commitments.

Indonesia today still utilises LCRs to promote certain industries, such as manufacturing, automotive, pharmacies, telecommunication, and electric vehicles. Section 2 outlines Indonesia's free trade agreement (FTA) regime. Section 3 reviews Indonesia's LCR policies and regulations, and Section 4 assesses their alignment with its FTAs. Section 5 reviews LCR policies in other countries, particularly in East Asia. Section 6 concludes and offers policy recommendations.

## **2. Indonesia's FTA Regime**

Indonesia currently has 16 FTAs and comprehensive economic partnerships (CEPs). Of these, 13 remain active, while the other three have been signed but have not yet entered into force. Indonesia is a member of the Association of Southeast Asia Nations (ASEAN); therefore, all FTAs in that context also apply to Indonesia. Table 1 lists the FTAs and CEPs that have been signed by Indonesia and are currently in force.

Beyond the 16 agreements included in Table 1, Indonesia is currently also in the process of negotiating an FTA with the European Union and is exploring the possibility to have trade agreements with other economies, including Canada, the Eurasian Economic Union, Kenya, Morocco, and South Africa.

Many literatures provide detailed study on economic impact of these FTAs to Indonesia's trade and investment, which mostly indicate positive linkages between FTAs and Indonesia's economy. A study by Damuri and Sudjito (2013) suggested that there was significant increase in the total trade between Indonesia and its partners (ASEAN member states, Japan, and China) after the respective FTAs entered into force. This study also suggested that Indonesia's exports to its FTA partners increased to US\$121.2 billion in 2012 from US\$25.8 billion in 1996. Foreign direct investment (FDI) inflows from Japan increased from around US\$1.37 billion in 2008 to US\$4.71 billion in 2013, while inflows from Republic of Korea (henceforth, Korea) increased from US\$301 million in 2008 to US\$2.2 billion in 2013 (Statistics Indonesia). A positive trend is also found from Australia and New Zealand, albeit in fluctuating numbers, with the FDI from Australia increasing from around US\$239 million in 2010 to US\$685 million in 2014, and FDI from New Zealand increasing from around US\$3 million in 2010 to US\$17.6 million in 2014.

A study by Cali et al. (2019) estimates that by 2030, the Indonesia–European Union Comprehensive Economic Partnership Agreement (I-EU CEPA) will increase Indonesia's accumulated GDP by 9.14%, while the Regional Comprehensive Economic Partnership (RCEP) will increase Indonesia's GDP by 0.4%. It also estimates that exports and imports will increase around 13% and 2.7% from the I-EU CEPA and the RCEP, respectively.

**Table 1. List of Indonesia's FTAs**

<b>No</b>	<b>Agreement</b>	<b>Partner(s)</b>	<b>Status</b>
1.	ASEAN Trade in Goods Agreement <sup>1</sup>	ASEAN Member States	In force since 2010
2.	ASEAN–Australia–New Zealand Free Trade Area Agreement (AANZFTA)	ASEAN Member States, Australia, New Zealand	In force since 2010
3.	ASEAN – Hong Kong, China Free Trade Agreement (AHKFTA)	ASEAN Member States, Hong Kong, China	In force since 2019
4.	ASEAN – China Free Trade Agreement (ACFTA)	ASEAN Member States, China	In force since 2005
5.	ASEAN – India Free Trade Agreement (AIFTA)	ASEAN Member States, India	In force since 2010
6.	ASEAN – Japan Comprehensive Economic Partnership (AJCEP)	ASEAN Member States, Japan	In force since 2008
7.	ASEAN – Korea Free Trade Agreement (AKFTA)	ASEAN Member States, Korea	In force since 2007
8.	Indonesia – Australia Comprehensive Economic Partnership (IA–CEPA)	Australia	In force since 2020
9.	Indonesia – Chile Comprehensive Economic Partnership Agreement	Chile	In force since 2019
10.	Indonesia – Pakistan Free Trade Agreement	Pakistan	In force since 2013
11.	Preferential Tariff Arrangement – Group of Eight Developing Countries	Bangladesh, Egypt, Iran, Malaysia, Nigeria, Pakistan, Turkey	In force since 2011

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<sup>1</sup> For the purpose of analysis in this paper, the ASEAN Comprehensive Investment Agreement and its subsequent amendments will be assessed in parallel with the ASEAN Trade in Goods Agreement.

12.	Indonesia – Japan Economic Partnership Agreement (IJEPA)	Japan	In force since 2008
13.	Indonesia – European Free Trade Association Free Trade Agreement	Iceland, Liechtenstein, Norway, Switzerland	In force since 2021
14.	Indonesia – Mozambique Free Trade Agreement	Mozambique	Signed in 2019, not yet in effect
15.	Indonesia – Korea Free Trade Agreement	Korea	Signed in 2020, not yet in effect
16.	Regional Comprehensive Economic Partnership (RCEP)	ASEAN Member States, Australia, China, Japan, Korea, New Zealand	Will enter into force 1 January 2022

ASEAN = Association of Southeast Asian Nations, FTA = free trade agreement.

Notes: The subsequent protocols or amendments of the FTAs identified in the table are not listed. They are, however, used for analysis in this paper.

Source: The Asian Development Bank (<https://aric.adb.org/database/fta> [accessed 9 November 2021]) and Indonesia's Ministry of Trade's website (<http://ditjenppi.kemendag.go.id/index.php/bilateral/fta-pta-cepa> [accessed 9 November 2021]).

### 3. Indonesia's LCR Policies and Regulations

LCR policies regained popularity after the Great Recession in 2008. The Organisation for Economic Co-operation and Development (OECD) identified 146 new LCR measures since the Great Recession through 2015. In terms of characteristics of imposing countries, the OECD found that, of the 146 LCR measures, around 58% are imposed by countries with gross domestic product (GDP) of more than US\$800 billion, while 54% of these measures are imposed by countries with more than 100 million population. This suggests that large economies tend to believe that their domestic markets are attractive enough for certain industries or firms to change their methods of production and develop a local industry (Stone, Messent, and Flaig, 2015).

This section focuses on LCR regulations that target specific sectors and confer certain benefits. Regulations that are related to LCRs, but in the context of government procurement, will not be assessed in detail because Indonesia does not currently have market access commitments on government procurement under the WTO or any FTAs. Additionally, regulations on technical guidelines in the methodology to calculate the percentage of local content will not be discussed in detail because they do not contain requirements or offer certain benefits.

The current LCR regime in Indonesia can be traced back to 2006 when the government introduced Minister of Industry Regulation No. 10 of 2006 Regarding the Use of Domestic Production Machineries to Obtain Facilities on Import Duties for Goods and Materials. Indonesia's efforts to implement the LCR regulations were reinforced in 2018 when President Joko Widodo issued Presidential Decision No. 24 of 2018 Regarding the National Team on Increased Use of Domestic Product. This team is tasked to monitor, supervise, evaluate, and promote the use of domestic products. A similar ambition is also reflected in the Strategic Plan of the Ministry of Industry 2020–2024, which sets 13 strategic objectives (*Sasaran Strategi–SS*) based on stakeholders, consumers, internal processes, and learning and growth perspectives. The SS-3 aims to increase capability of local industry with the following indicators:

- a. The target of local content (weighted average), which is 49% in 2020, will be 53% in 2024.
- b. The target of local content in government procurement (goods and services), which is 46.63% in 2020, will be 52.48% in 2024.
- c. Products that are certified to have  $\geq 25\%$ , which is targeted to be 6,200 products in 2020, will be 8,400 products in 2024.
- d. The percentage of *Standard Nasional Indonesia* in industries was set to 5% in 2020, and will be 20% in 2024.

In general, Indonesia's laws and regulations on LCRs can be categorised into several groups. The first is those that only deal with government procurement, such as i) Law No. 3 of 2014 on Industry; ii) Presidential Decree No. 16 of 2018, which is amended by Presidential Decree No. 12 of 2021 on Government Procurement for Goods and Services; iii) Minister of Industry Regulation No. 48 of 2010 on

Guidelines on Utilization of Domestic Products in Development of Electricity Infrastructure; iv) Minister of Industry Regulations No. 16 of 2020 on Provisions and Procedures of Local Content Calculation for Pharmaceutical Products; and v) Government Regulation No. 29 of 2018 on Industry Empowerment. These regulations might be useful for companies as guidelines to calculate the percentage of local content, if they want to participate in government procurement activities.

The second group is those that are related to LCRs, but do not necessarily require the use of domestic products to conduct business or to obtain certain benefits. Some of these regulations are: i) Presidential Decree No. 146 of 2015 on Construction and Development of Oil Refinery, which only encourages this sector to prioritise domestic products; and ii) Minister of Trade Regulation No. 71 of 2019 on Operation of Franchises, which encourages franchise businesses to prioritise domestic products.

The third group is those that calculate local content for certain products, without requiring those products to use it. Some examples of these regulations are: i) Minister of Industry Regulation No. 29 of 2017 on Procedures to Calculate Local Content of Cell Phones, Laptops, and Tablet Computers; ii) Minister of Industry Regulation No. 22 of 2020 on Procedures to Calculate Local Content on Electronics and Telematics Products; and iii) Minister of Industry Regulation No. 27 of 2020 on Specification, Roadmap for Development, and Calculation of Local Content for Battery Electric Vehicles.

The fourth group is those that require the use of local content or domestic products to conduct business, or those that provide certain benefits or incentives if local content or domestic products are used. These regulations would be the ones relevant to Indonesia's FTA commitments. Table 2 provides the list of Indonesia's LCR regulations that fall under this group.

**Table 2. List of Indonesia’s Local Content Requirement Regulations  
Relevant to Indonesia’s Free Trade Agreement Commitments**

<b>No</b>	<b>Regulation</b>	<b>Local Content Requirements</b>	<b>Benefits Granted</b>	<b>Covered Sector(s)</b>
1.	Minister of Communication and Information Regulation No. 7 of 2009 concerning Radio Frequency Band Setup for Wireless Broadband Services	Minimum 30% local content for “subscriber station” and minimum 40% local content for “base station”. The requirement is increased to 50% within 5 years.	Requirement for wireless broadband services in Indonesia. There are no additional benefits.	Tele-communication
2.	Minister of Industry Regulation No. 54 of 2012 on Guidelines in Utilizing Domestic Products for Construction of Infrastructure on Electricity	Certain percentage of local content for construction of power plants.	Requirement to be able to construct power plants. There are no additional benefits.	Energy
3.	Minister of Trade Regulation No. 7 of 2013 concerning Development of Partnership for Food and Beverages Franchises	Requirement for food and beverage franchises to source 80% of their raw materials and equipment domestically.	Requirement to operate the franchise. There are no additional benefits.	Food and Beverage
4.	Minister of Communication and Information Regulation No. 32 of 2013 concerning Operation of Digital	Requirement for digital television receiver device (set-top-box) to have minimum 20% local content. The	Requirement for the device to be traded or used in Indonesia. There are no additional benefits.	Tele-communication



<b>No</b>	<b>Regulation</b>	<b>Local Content Requirements</b>	<b>Benefits Granted</b>	<b>Covered Sector(s)</b>
	Television and Multiplexing Broadcasting through the Terrestrial System	requirement is increased to 50% within 5 years.		
5.	Minister of Energy and Natural Resources Regulation No. 15 of 2013 concerning the Use of Domestic Products in Upstream Oil and Gas Businesses	<ul style="list-style-type: none"> <li>• Requirement to use certain percentage of domestic products and services in upstream oil and gas businesses.</li> <li>• Price preference for domestic products.</li> </ul>	Businesses will be accorded with ranks based on compliance and will be fined for non-compliance.	Energy
6.	Minister of Communication and Information Regulation No. 27 of 2015 on Technical Requirements for Telecommunication Devices with LTE Technology	Minimum 30% local content for “base station” and minimum 20% local content for “subscriber station”. The requirement increased in 2017 and 2019.	Requirement for telecommunication devices with LTE technology to be allowed to be traded or used in Indonesia. There are no additional benefits.	Tele-communication
7.	Minister of Industry Regulation No. 15 of 2016 on Technical and Price Standards for Domestic Transmission Tower and Conductor in Relation to Acceleration of	Minimum 40% local content for transmission tower and conductor	Requirement for transmission towers and conductors in Indonesia. There are no additional benefits.	Energy

<b>No</b>	<b>Regulation</b>	<b>Local Content Requirements</b>	<b>Benefits Granted</b>	<b>Covered Sector(s)</b>
	Development of Infrastructure on Electricity, as amended by Minister of Industry Regulation No 6 of 2018, and Minister of Industry Regulation No. 24 of 2020			
8.	Minister of Communication and Information Regulation No. 6 of 2017 concerning Operation of Internet Protocol Television Services	Requirement for Internet Protocol Set-Top-Box to have minimum 20% local content. This requirement is increased to 50% in 5 years.	Requirement for the device to be used in Indonesia. There are no additional benefits.	Tele-communication
9.	Minister of Industry Regulation No. 34 of 2017 on 4-Wheeled or more Automotive Industry, as amended by Minister of Industry Regulation No. 5 of 2018, and as replaced by Minister of Industry Regulation No. 23 of 2021	The import of certain vehicles using IKD scheme should use local components within 5 years at the latest since the date of approval.	To secure approval for IKD import and to obtain preferential import tariffs.	Automotive
10.	Head of Investment Coordinating Board Regulation No. 6 of 2018 on Guidelines regarding Investment	Minimum 30% local content in the machines used for production	<ul style="list-style-type: none"> <li>• Incentives on importation of goods and raw materials for 4 years</li> </ul>	Investment

No	Regulation	Local Content Requirements	Benefits Granted	Covered Sector(s)
	Approval and Facilitation		<ul style="list-style-type: none"> <li>• Extension of incentives of up to 4 years</li> </ul>	
11.	Presidential Regulation No. 55 of 2019 on Acceleration of Battery Electric Vehicle for Road Transportation Program	<p>Requirement to produce BEV with certain percentage of local content.</p> <p>2- to 3-wheel vehicle:</p> <ul style="list-style-type: none"> <li>➔ 2019–23: 40%</li> <li>➔ 2024–25: 60%</li> <li>➔ 2026–onwards: 80%</li> </ul> <p>4-wheel vehicle</p> <ul style="list-style-type: none"> <li>➔ 2019–21: 35%</li> <li>➔ 2022–23: 40%</li> <li>➔ 2024–29: 60%</li> <li>➔ 2030–onwards: 80%</li> </ul>	<p>Fiscal and non-fiscal incentives for compliance, including:</p> <ul style="list-style-type: none"> <li>• import duty incentives for BEV that are imported using CKD and IKD scheme, and imported components during certain period;</li> <li>• incentives for sales tax on luxury goods;</li> <li>• exemption or reduction of central/regional taxes;</li> <li>• suspension of import duties for export purposes;</li> <li>• export financing incentives;</li> <li>• exemption from certain road restriction; and</li> <li>• right for production in the case of BEV technology patent is owned by central</li> </ul>	Electric Vehicle

<b>No</b>	<b>Regulation</b>	<b>Local Content Requirements</b>	<b>Benefits Granted</b>	<b>Covered Sector(s)</b>
			and/or regional government.	
12.	Minister of Communication and Information Regulation No. 4 of 2019 on Technical Requirements for Telecommunication Devices for Television and Radio Broadcasting	Minimum 20% local content for broadcasting devices and internet protocol set top box	Requirement for broadcasting devices to be allowed to be traded or used in Indonesia. There are no additional benefits.	Tele-communication
13.	Minister of Communication and Information Regulation No. 12 of 2019 concerning Procedure for Assessing Achievement of Domestic Component in Capital and Operational Expenditure of Telecommunications Operator	Requirement for telecommunication operators to meet certain level of local content in their capital and operational expenditures	Requirement for telecommunication operators. There are no additional benefits.	Tele-communication

BEV = Battery Electric Vehicles, CKD = Completely Knocked Down, IKD = Incomplete Knocked Down, LTE = Long-Term Evolution.

Note: This table cover regulations between 2000–20. It does not include laws or regulations on procedural and administrative matters, such as Presidential Decree on the Establishment of National Team on Increased Use of Domestic Product, methodology to calculate the local content on certain products, or technical guidelines on government procurement activities.

Source: Authors.

#### **4. Consistency of Indonesia's LCR Policies with Its Commitments in FTAs**

LCR policies are complex; therefore, there are some disciplines under international trade law that concern them. The framework of the WTO concerns four Agreements, which will be elaborated below. This is relevant for Indonesia's FTA commitments because some of them incorporate or refer to the relevant provisions from the WTO Agreements.

Previous disputes in the WTO suggest that different Agreements look at different aspects of LCRs. Therefore, the same LCRs can be subject to multiple WTO rules. For example, the Panel in the *Indonesia – Autos (WT/DS54/R; WT/DS55/R; WT/DS59/R; WT/DS64/R)* case, stated that Article III of the General Agreement on Tariffs and Trade (GATT) prohibits discrimination between domestic and imported products while the Agreement on Subsidies and Countervailing Measures (ASCM) regulates the provision of subsidies to enterprises. Similarly, the Trade-Related Investment Measures (TRIMs) Agreement and the ASCM target different aspects of LCRs. In the case of the ASCM, what is prohibited is the grant of a subsidy contingent on use of domestic goods, not the requirement to use domestic goods as such. In the case of the TRIMs Agreement, what is prohibited are TRIMs in the form of LCRs, not the grant of an advantage, such as a subsidy. Similarly, in the context of FTAs, one LCR regulation can be subject to multiple provisions.

##### **The General Agreement on Tariffs and Trade**

As LCR policies essentially provide preference for domestic products over imported products, this concerns the 'National Treatment' provision stipulated under Article III. Paragraph 4 of Article III of the GATT requires imported products to be treated no less favourably compared with domestic products with respect to laws and regulations affecting their sale or use. Some authors also argue that paragraphs 1, 5, and 8 are related to LCR policies (Weiss, 2016).

## **The Agreement on Trade-Related Investment Measures**

TRIMs cover investment between WTO members in the area of trade in goods, but not services. Article II of the TRIMs Agreement stipulates that no WTO Members shall apply any trade-related investment measures that are inconsistent with Article III of the GATT.

This article also provides an illustrative list of measures that are inconsistent with Article III of the GATT. Relevant parts of paragraph 1 of the illustrative list provide:

1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

(a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.

## **The Agreement on Subsidies and Countervailing Measures**

Article 3 of the ASCM prohibits export subsidies and local content subsidies because they are designed to directly affect trade and thus are most likely to have adverse effects on the interests of other Members. Article 1 of the ASCM defines subsidies, which is a financial contribution or price support by a government that confers a benefit. Considering that some LCR regulations provide certain types of benefits to firms that comply with them, these could also be considered as subsidies.

## **The Agreement on Government Procurement**

The Agreement on Government Procurement (GPA) is currently a Plurilateral Agreement in the WTO, which means that it applies only to Members who ratify it. One of the general principles provided in Article IV of the GPA is non-discrimination, where GPA Parties must ensure that domestic goods, services, and suppliers are treated equally in 'covered government procurement'. However, since Indonesia is not a party to the GPA, this obligation does not apply to it.

#### **4.1. Relevant Provisions in Indonesia's FTAs**

Indonesia currently has 16 FTAs, 13 of which are in effect, while three are still pending ratification. Table 3 lists the provisions from these agreements that are relevant to LCRs.

In Indonesia's FTAs, the disciplines of National Treatment pertain to Article III of the GATT. This approach would mean that if a regulation is found to be inconsistent with Article III, it is also inconsistent with the relevant provisions in the FTAs. With regard to ASCM provisions, Indonesia's FTAs generally reaffirm the stipulated rights and obligations of countries. However, the discipline on 'prohibition of performance requirements' in some of Indonesia's FTAs differs from those under the TRIMs Agreement.

With regard to government procurement, the RCEP is the only FTA where Indonesia includes a relevant chapter. However, the commitment in the Government Procurement Chapter of the RCEP Agreement is limited to transparency and cooperation, with no market access commitment. Therefore, Indonesia's LCR regulations related to government procurement are not relevant because Indonesia does not have a correlating commitment in its FTAs.

Indonesia's LCR regulations that do pertain to its FTA commitments are identified in Table 2. In general, these regulations either: 1) require the use of local content or domestic products to conduct business; or 2) provide certain benefits or incentives if local content or domestic products are used.

**Table 3. List of Provisions in Indonesia's Trade Agreements that are Relevant to Local Content Requirements**

<b>No.</b>	<b>Agreement</b>	<b>National Treatment</b>	<b>Subsidy and Countervailing Measures</b>	<b>Prohibition of Performance Requirements</b>
1.	ASEAN Comprehensive Investment Agreement (ACIA)	Article 6 <sup>a</sup>	Article 87 <sup>b</sup>	Article 7 of ACIA, as amended by 4th Protocol of ACIA
2.	ASEAN–Australia–New Zealand Free Trade Area Agreement	Article 4 <sup>a</sup> of Chapter 2	N/A	Article 5 of Investment Chapter
3.	ASEAN – Hong Kong, China Free Trade Agreement	Article 5 <sup>a</sup> of Chapter 2	Article 1 <sup>b</sup> of Chapter 7	N/A
4.	ASEAN – China Free Trade Agreement	Article 2 <sup>a</sup>	Article 7 <sup>b</sup>	N/A
5.	ASEAN – India Free Trade Agreement	Article 3 <sup>a</sup>	N/A	N/A
6.	ASEAN – Japan Comprehensive Economic Partnership	Article 15 <sup>a</sup> of Chapter 2	N/A	N/A
7.	ASEAN – Korea Free Trade Agreement	Article 2 <sup>a</sup>	N/A	Article 6 <sup>c</sup>
8.	Indonesia – Australia Comprehensive Economic Partnership	Article 2.4 <sup>a</sup>	N/A	Article 14.6
9.	Indonesia – Chile Comprehensive Economic Partnership Agreement	Article 3.3 <sup>a</sup>	Article 8.2 <sup>b</sup>	N/A



No.	Agreement	National Treatment	Subsidy and Countervailing Measures	Prohibition of Performance Requirements
10.	Indonesia – Pakistan Free Trade Agreement	Article 5 <sup>a</sup>	Article 5 <sup>b</sup>	N/A
11.	Preferential Tariff Arrangement – Group of Eight Developing Countries	Article 8 <sup>a</sup>	Only confirmation that Parties have rights to initiate investigations	N/A
12.	Indonesia – Japan Economic Partnership Agreement	Article 19 <sup>a</sup>	N/A	Article 63 <sup>c</sup>
13.	Indonesia – European Free Trade Association Free Trade Agreement	Article 2.9 <sup>a</sup>	Article 2.14 <sup>b</sup>	N/A
14.	Indonesia – Mozambique Free Trade Agreement	Text not available	Text not available	Text not available
15.	Indonesia – Korea Free Trade Agreement	Text not available	Text not available	Text not available
16.	Regional Comprehensive Economic Partnership (RCEP)	Article 2.3 <sup>a</sup>	Article 7.11 <sup>b</sup>	Article 10.6 <sup>c</sup>

ASEAN = Association of Southeast Asian Nations.

Notes:

a: National Treatment provisions in these Agreements normally are reaffirmation of rights and obligations under General Agreement on Tariffs and Trade 1994 or incorporation of Article III, *mutatis mutandis*.

b: Provisions on subsidies and countervailing measures in these Agreements are reaffirmation of rights and obligations in the Agreement on Subsidies and Countervailing Measures of the World Trade Organization.

c: Performance requirements in these Agreements are a reaffirmation of rights and obligations under Trade-Related Investment Measures or incorporation of relevant provisions.

Source: Authors' compilation.

#### **4.2. Consistency with National Treatment Principle under GATT**

The provisions of Article III of the GATT certainly ban LCRs that set a required minimum for the consumption of local goods (Shadikhodjaev, 2018). There are a few paragraphs from Article III that are relevant to LCRs, namely 4, 5, and 8. Paragraph 8, which focuses on government procurement activities, does not concern Indonesia because it does not have market access commitment on government procurement. Paragraphs 4 and 5 of Article III of the GATT 1994 read as follows:

Paragraph 4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

Paragraph 5. No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.

Paragraph 5 clearly stipulates that WTO members are not allowed to require any specified amount or proportion of any product to be supplied from domestic sources. While paragraph 5 has been cited in 11 disputes in the WTO, there is no decision from the Panel or the Appellate Body. In some of these cases, the Panel and the Appellate Body decided that they have made the findings that are necessary for the resolution of the dispute, after making decision for claims under Articles III:2 and III:4.

Paragraph 4 requires WTO members to accord imported products *treatment no less favourable* than that accorded to like products of national origin. In the *United States – Section 337* dispute, the panel found:

A formal difference in treatment between imported and like domestic products is thus neither necessary, nor sufficient, to show a violation of Article III:4. Whether or not imported products are treated ‘less favourably’ than like domestic products should be assessed instead by examining whether a measure modifies the *conditions of competition* in the relevant market to the detriment of imported products.

This means that treating imported and domestic products differently does not automatically make a regulation inconsistent with Article III:4. However, a measure will be inconsistent with this paragraph if the regulation adversely affects the conditions of competition for the imported products in the relevant market. The Appellate Body in *Brazil – Taxation* said:

The ICT programmes are designed in a manner that creates incentives for the market participants, that is, purchasers of intermediate ICT products, to behave in a manner that has the ‘direct practical effect’ of treating imported intermediate ICT products less favourably than like domestic intermediate ICT products. In this case, by creating an incentive to purchase incentivized domestic intermediate ICT products in order to be relieved from and/or to face reduced administrative burdens. Accordingly, we agree with the Panel that, ‘when faced with a decision to choose’, a purchaser, ‘under normal circumstances, will prefer to avoid the administrative burden that comes with the payment of the tax’ and thus prefer to purchase incentivized domestic intermediate ICT products.

The jurisprudence in the WTO suggests that incentivising businesses to use domestic products would be inconsistent with Article III:4 of the GATT 1994. A number of Indonesia’s LCR regulations do provide incentives for using domestic products, for example, Presidential Regulation No. 55 of 2019 on Acceleration of Battery Electric Vehicle for Road Transportation Program and Minister of Industry Regulation No 34 of 2017 on 4-Wheeled or More Automotive Industry. Therefore,

it is likely that these regulations are to be found inconsistent with Indonesia's commitment under Article III:4 of the GATT 1994. Considering the approach in Indonesia's FTAs where the National Treatment principle is often incorporated *mutatis mutandis*, the same legal analysis can be applied, and the same conclusion can be drawn.

#### **4.3. Consistency with Subsidies and Countervailing Measures Provisions**

Subsidy and Countervailing Measure (SCM) provisions in Indonesia's FTAs are merely a reaffirmation of rights and obligations of contracting Parties under the WTO's ASCM, as indicated in Table 3. Some FTAs do not even have provisions on SCM. In the RCEP Agreement, there are several procedural provisions for Anti-Dumping and Countervailing Duties, but nothing that will affect Indonesia's rights and obligations under the relevant Agreements in the WTO. Additionally, the Section on Anti-Dumping and Countervailing Duties in the RCEP Agreement is carved out from a dispute settlement.

Indonesia's FTAs make insignificant, if not zero, changes to its rights and obligations under the WTO. It appears that countries have not put subsidy programmes on the table in their Regional Trade Agreement negotiations and thus feel a continuing need for countervailing duties as a weapon to wield against such support (Teh et al., 2007). Another reason that countries, including Indonesia, do not include substantive commitments on SCM is they prefer to address the issue of subsidies using the existing mechanism in the WTO instead of creating another process under the FTAs. Therefore, these FTAs do not create additional obligations or commitments to Indonesia, particularly in terms of LCRs.

#### **4.4. Consistency with Provision on Prohibition of Performance Requirements**

Indonesia has six FTAs that have a provision on Prohibition of Performance Requirements in their Investment Chapter, as indicated in Table 3. However, this provision was drafted in a rather simple way in the ASEAN–Australia–New Zealand Free Trade Area Agreement (AANZFTA) and the ASEAN–Korea Free Trade Agreement. Article 6 of ASEAN–Korea Investment Agreement incorporates provisions of the TRIMs Agreement, *mutatis mutandis*. Meanwhile, Article 5 of AANZFTA Investment Chapter provides that:

No Party shall apply in connection with the establishment, acquisition, expansion, management, conduct, operation, or sale or other disposition of an investment of an investor of a Party in its territory any measure which is inconsistent with the Agreement on Trade-Related Investment Measures in Annex 1A to the WTO Agreement.

This approach means that relevant provisions on LCRs in the TRIMs Agreement will apply to Indonesia. As mentioned above, Article 2.1 of the TRIMs Agreement prohibits countries to apply trade-related investment measures that are inconsistent with the provisions of Article III or Article XI of GATT 1994. The jurisprudence in the WTO suggests that, to be inconsistent with this Article, an investment measure must be related to trade. The Panel in *Indonesia-Autos* decided that, to be an investment measure, the regulation does not have to be introduced by the investment body. The Panel found that Indonesia's measures were aimed at encouraging a local manufacturing capability for finished motor vehicles and parts and components. Inherent to this objective is that these measures necessarily have a significant impact on investment in these sectors.

Similarly, the Panel in *Canada – Renewable Energy / Feed-in Tariff (FIT) Program* found that the 'minimum required domestic content level' in Canada's measure constituted investment measures related to trade in goods within the meaning of Article 1 of the TRIMs Agreement. This is also based on the evidence that one of the aims of the FIT Program and the FIT and microFIT Contracts is to encourage investment in the local production of equipment associated with renewable energy generation in the Province of Ontario. Considering this jurisprudence, Indonesia's LCR regulations can be categorised as investment measures because they aim to develop specific local sectors and to encourage investment in products subject to them.

Indonesia's LCR regulations identified in Table 3 also appear to match the description in paragraph 1(a) of the Illustrative List of TRIMs. These regulations do require the purchase or use of domestic products, either in terms of value or volume. The Panel in *India – Solar Cells* found that TRIMs falling under paragraph 1(a) of the TRIMs Illustrative List are necessarily inconsistent with Article III:4 of

the GATT 1994. Therefore, it is likely that these regulations are to be found inconsistent with Indonesia's commitment under AANZFTA and AKFTA.

The other four FTAs, namely the ACIA, the IJEPA, the IA–CEPA, and the RCEP Agreement, have more elaborated provisions on Prohibition of Performance Requirements, where they share many similarities. Relevant parts of Article 10.6 in the RCEP Agreement provide the following:<sup>2</sup>

1. No Party shall impose or enforce, as a condition for establishment, acquisition, expansion, management, conduct, operation, or sale or other disposition of an investment in its territory of an investor of any other Party, any of the following requirements:
  - (a) (...);
  - (b) to achieve a given level or percentage of domestic contents;
  - (c) to purchase, use, or accord a preference to goods produced in its territory, or to purchase goods from person in its territory; ....
  
2. No Party shall condition the receipt or continued receipt of an advantage, in connection with the establishment, acquisition, expansion, management, conduct, operation, or sale or other disposition of an investment in its territory of an investor of any other Party on compliance with any of the following requirements:
  - (a) to achieve a given level or percentage of domestic contents;
  - (b) to purchase, use, or accord a preference to goods produced in its territory, or to purchase goods from person in its territory; (...)

These two paragraphs prohibit a Party to the Agreement from requiring investors to achieve a certain level or percentage of domestic content, or to source goods that are produced in its territory, as a condition to do activities enumerated in the chapeau of paragraphs 1 and 2. Similar provisions can also be found in the ACIA, the IJEPA, and the IA–CEPA, with slight variations on what activities are covered in the chapeau of paragraphs 1 and 2.

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<sup>2</sup> <https://rcepsec.org/wp-content/uploads/2020/11/Chapter-10.pdf>.

Indonesia's LCR regulations identified in Table 2 require the two things provided in the above paragraphs. For example, Minister of Communication and Information Regulation No. 27 of 2015 requires all devices with 'long-term evolution' technology in Indonesia to have minimum 30% local content for 'base stations' and a minimum of 20% local content for 'subscriber stations'. There is no jurisprudence from these FTAs that could be used to interpret the meaning of these provisions. However, based on their ordinary meaning, it is likely that Indonesia's LCR regulations inconsistent with these paragraphs.

## **5. Review of LCR Policies in East Asia and Other Countries**

Adoption of LCR policies to develop a specific sector or industry is not uncommon. There are a handful of countries that adopted LCR policies in the past, and their experience could shed some light for Indonesia. Some of these countries abandoned the LCR policies, some were brought to dispute in the WTO, and some were arguably successful.

### **5.1. Thailand's Automotive Industry**

Thailand is one of the countries that adopted LCR policies in the past, with the objective of developing its automotive industry. Warr and Kohpaiboon (2017) explain Thailand's policy environment to develop the automotive industry. Thailand started to encourage domestic production of vehicles in the early 1960s by imposing high import tariffs for 'completely built up' and 'completely knocked down' cars. In 1982, Thailand required all vehicles to have 45% domestic content; this was increased to 54% in 1986. Additionally, Thailand also required foreign manufacturers to operate in joint ventures with domestic partners.

The policies changed in the 1990s for at least three reasons: first, Thailand's commitments under the TRIMs Agreement, the policies of the reform-oriented government, and the Asian Financial Crisis. Second, Thailand's commitment under TRIMs required them to remove restrictions on foreign ownership and the Asian Financial Crisis made foreign investments urgently needed. Third, the currency depreciation also made it more profitable for manufacturers in Thailand to export their products. In 2000, Thailand abolished LCRs for domestically located final

assemblers. The combination of these events and policies became the turning point for Thailand's automotive industry and now it is one of the countries where car manufacturers locate their factories.

Aside from changes in trade policy, public investment in infrastructure also played a big role in the development of Thailand's automotive industry. However, the policy changes are one of the key factors of Thailand's success, considering that its neighbours such as Indonesia and Malaysia, who did not adopt such policies, were left behind.

## **5.2. China's Automotive Industry**

China surpassed the US as the largest automotive market and producer in 2009 based on the data from the Association of Automobile Manufacturers, as cited by the Chinese Embassy to the US (Jie, 2010). However, LCR policies were adopted in China's automotive industry decades ago. Although China had to revise many of its laws and regulations on LCRs, a study by Hufbauer, et al. (2013a) found that they persist through foreign ownership requirements, financing arrangements, and informal government suggestions. The informal administration also means that a WTO challenge would encounter very high evidentiary hurdles.

The study also suggested that Chinese officials use encouragement to transfer technology and use local content instead of formal requirement to foreign companies. However, this creates worry for companies that the encouragement can become obligatory, particularly given the high degree of discretion of Chinese officials when reviewing investment applications or to recommend a Chinese bank loan. The study found that auto prices in China may be 7% higher than they would be with reformed policies and an appreciated exchange rate. However, they also acknowledged that China's automotive policies have accomplished their mission to develop the automotive industry.

## **5.3. LCRs of Some Countries in the Energy Sector**

A study by Silva for the United Nations Conference on Trade and Development (UNCTAD) in 2014 found that several countries had been successful in using LCRs to develop their domestic energy sector. For example, Brazil transformed its state-owned enterprise, Petrobras, into a global energy player by



introducing a policy where contractors are required to purchase local goods and services only when they are competitive on cost and quality with foreign suppliers. Malaysia developed its state oil company, Petronas, by pursuing an aggressive human resources strategy that requires firms under production-sharing contracts to secure equipment, facilities, goods, materials, and services locally unless a waiver is granted. Norway developed its domestic industry by investing in research and development, as well as building strong links between private firms and local academic centres. Norway also gave preference to domestic firms when they were considered competitive. Additionally, companies were required to conduct at least 50% of the research for technology needed to develop prospects in Norway at local institutions.

In the study by UNCTAD, the lesson is that local content requirements must focus on capacity building and value added rather than mere ownership. The golden rule is to give priority to local products and services only when they are competitive in terms of price, quality, and timely availability.

India also used LCRs in developing its solar power industry in the past decade. The Indian Government introduced the Jawaharlal Nehru National Solar Mission in 2010 with the objective to ‘establish India as a global leader in solar energy, by creating the policy conditions for its diffusion across the country as quickly as possible.’<sup>3</sup> Under this programme, India purchases solar power generated by developers through a 25-year term contract, with guaranteed rates that are determined by two Indian electricity regulatory commissions. The LCR aspect in this programme is how India imposed domestic content requirements on participating solar power developers. This regulation was challenged by the US at the WTO (WT/DS/456), and it was found to be inconsistent with National Treatment provisions under the GATT and the TRIMs Agreement. However, the programme can be considered relatively successful in developing India’s solar industry. A study by the International Renewable Energy Agency in 2018 found that India was producing the world’s cheapest solar power. This is due to some

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<sup>3</sup> <https://www.indiascienceandtechnology.gov.in/st-visions/national-mission/jawaharlal-nehru-national-solar-mission-jnnsn>

factors, such as low cost of labour, and land certainty, but also the incentives and LCR policy (Karan, 2019).

Many studies have suggested alternatives to LCR policies. A study suggested that creating a business-friendly environment, encouraging corporate social responsibility, expanding training, improving logistics, increasing investment in infrastructure, and imposing tariffs and subsidies could deliver more job creation, impose fewer costs on the economy, and generate more economic growth (Hufbauer et al., 2013b). Another study noted that there are alternatives to LCRs such as the ‘lighter touch’ of industrial policy measures, exploiting flexibilities under trade agreements, corporate social responsibility, and exploiting the ‘water’ in the tariffs. However, it is acknowledged that there is no ready-made policy tool that can be applied across the board as a perfect substitute to what are and remain WTO-illegal LCR measures (Sauvé, 2016).

## **6. Conclusion and Recommendations**

Indonesia adopted LCR regulations decades ago. Today, Indonesia still utilises LCR regulations to develop several industries; some of these are questioned by WTO members in the TRIMs Committee (WTO, 2020). These regulations are likely to be found inconsistent with Indonesia’s commitment to its FTAs, particularly with regard to the principles of National Treatment and provision on Prohibition of Performance Requirements.

Government procurement is one area where Indonesia has many regulations on LCRs. Unlike regulations for commercial businesses, LCRs in government procurement can still be in Indonesia’s toolkit. This is because Indonesia does not have any market access commitment on government procurement in its FTAs, or even in the WTO.

Many countries have used and are using LCR policies. Some of these countries were successful, but some others abandoned the policies. Countries that successfully utilised LCRs share similarity, where they focus on capacity building and value added of their domestic industry, instead of focusing merely on local ownership. Additionally, governments of these countries also invest in research and development, as well as building the human resources. In many of these cases,

preference will only be given to domestic companies or products only if they are competitive in terms of price and quality. Otherwise, affording protection to domestic producers without encouraging them to be competitive would run against the objective of developing competitive domestic industries.

The establishment of the National Team on Increased Use of Domestic Product was a good effort by the Indonesian government to have a coordinated effort in implementing LCRs. This is because LCR regulations can be introduced not only by Ministry of Trade, but also other ministries or agencies, making interagency coordination important. The Ministry of Trade can assess whether the LCR regulations introduced by other ministries or agencies will violate Indonesia's trade commitments. In cases where the LCR regulations are found to potentially violate Indonesia's trade commitments, there should be a calculation of risk and strategy in case there are questions, complaints, or even disputes from other countries.

There are several alternative policy tools available to achieve the same objective of promoting and developing local industries, which are consistent with Indonesia's trade commitments. For example, Indonesia could raise the tariffs to the bound rate for certain products, utilise corporate social responsibility, and using LCRs for government procurement activities. However, it should be noted that the other countries' experience appears to show that there is no single policy that can achieve this objective. A mix of policies to create a business-friendly environment, encourage research and innovation, investment in infrastructure, as well as building the capacity of human resources would be necessary to nurture domestic industries and enhance competitiveness.

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