



Localization Barriers to Trade: Threat to the Global Innovation Economy **Executive Summary**

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EXECUTIVE SUMMARY

The global economic downturn has intensified pressure on governments to boost their countries' sagging growth rates. Unfortunately, this has led increasingly to policymakers turning to a range of trade-distorting mercantilist measures intended to generate growth in the short-term by reducing imports and/or increasing exports. This explains why the number of technical barriers to trade reported to the World Trade Organization in 2012 reached an all-time high. In particular, a rapidly growing number of countries, including Argentina, Brazil, China, and India (among many others), have come to embrace a new kind of mercantilist trade policy that seeks to pressure foreign enterprises to “localize” economic activity so that these countries can create domestic jobs. These localization barriers to trade (LBTs) pressure foreign enterprises to produce locally what they would likely produce elsewhere and export to the recipient nation.

Though LBTs can produce some short-term gains for economies, in reality they are not an unalloyed good, and they are downright harmful to the global economy. Moreover, when countries resort to competing by using LBTs, they often neglect the superior opportunity to enact a range of pro-innovation and pro-productivity policies that can spur innovation and productivity across all industries.

A FRAMEWORK FOR UNDERSTANDING GLOBAL ECONOMIC DEVELOPMENT POLICIES

There are essentially four types of economic development policies that countries are currently implementing. (See Figure 1) Three have as their central aim the mercantilist goal of accelerating growth by reducing imports and/or increasing exports. The policies are:

1. **“Localization barriers to trade”**: These policies pressure foreign firms to shift production and/or intellectual property (IP) to the nation implementing them. These include local content requirements, forced offsets, and forced IP or technology transfer as a condition of market access.
2. **“Indigenous innovation”**: These policies provide preferential treatment of domestic enterprises at the expense of foreign ones. Policies include providing benefits only to domestically owned firms, making it more difficult for foreign enterprises to compete locally, such as by using domestic technology standards or onerous regulatory certification requirements; or blocking foreign competitors from domestic markets.
3. **“General mercantilism”**: These policies, such as currency manipulation or high tariffs, seek to boost production by increasing exports and/or reducing imports—by making imports more expensive and exports cheaper—but they are indifferent as to whether they affect domestic or foreign enterprises.
4. **“Enterprise support”**: These policies seek growth through higher productivity and increased innovation—regardless of whether the sector is “traded” or not—and aim more to assist, rather than coerce, enterprises. While virtually all countries have policies in this category, for an increasing number the relative “share” of these policies has been shrinking.

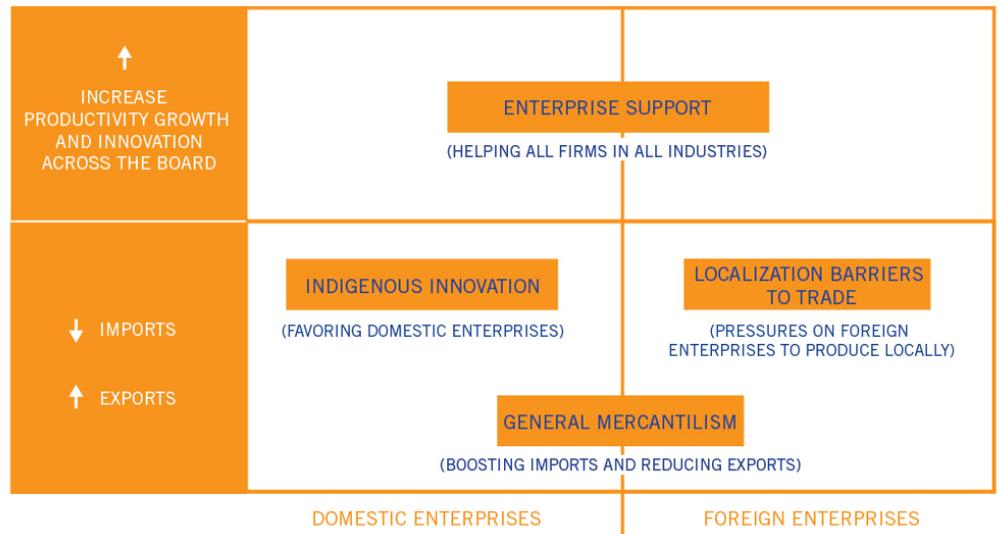


Figure 1: A Matrix for Understanding Global Economic Development Policies

LOCALIZATION BARRIERS TO TRADE

LBTs can be classified into four major categories—local content requirements, local production as a condition of market access, forced offsets, and forced intellectual property or technology transfer. All place geographic restrictions on the location of economic activity.

Local content requirements—the most common and rapidly growing type of LBT—mandate that a certain percentage of goods or services sold in a country be produced with local content. In 2010, LCRs affected 5 percent, or \$928 billion, of the \$18.5 trillion total global trade in goods and services. LCRs lead to an estimated reduction in world trade of almost \$100 billion per year. Countries define “local content” in a variety of ways, such as the percentage of local components used in the assembly of a final product; the share of locally developed IP embodied in the development of a product or service; or even the share of locally produced content in the broadcasting and audio/visual sectors. Countries apply LCRs to both public and private procurement and they affect virtually all sectors of economic activity, from information and communications technology (ICT) products, energy, and life sciences to digital services. For example, India’s Preferential Market Access (PMA) mandate will require that foreign enterprises incorporate 25 to 40 percent local content if they wish to serve India’s public ICT markets.

Another form of LBT mandates local production of a product or service as a condition of market access. For example, requirements that enterprises must use local ICT infrastructure—such as local data centers—to provide digital services such as Internet search to an economy effectively manifest a requirement of local production as a condition of market access. Some two dozen countries have introduced local data center or related data storage requirements. For instance, Vietnam’s Decree 72, which took effect in September 2013, mandates that all Web-based services providers (e.g., Facebook and Google, etc.) operate at least one data center in Vietnam.

Forced offsets encompass a range of industrial compensation arrangements required by foreign governments, historically as a condition of public procurement contracts, though now increasingly as part of private-sector procurements. For example, Japan, India, and Israel have required forced offsets as a condition of their countries' airlines purchases of jet aircraft, while others such as Turkey are seeking to do so.

Finally, requirements that foreign enterprises transfer intellectual property or technology as a condition of market access—often as part of required joint ventures—have become increasingly widespread. Such requirements constitute LBTs because they force companies to give up technology or IP as a condition of competing in a country. For example, China has imposed forced technology transfer requirements on foreign enterprises seeking to compete in dozens of markets, from automobiles and high-speed rail to steel and renewable energy. In life sciences, many nations have turned to compulsory licenses that mandate the transfer of intellectual property to a country's own domestic manufacturers so they can produce goods (i.e., pharmaceutical drugs) in country.

WHY LOCALIZATION BARRIERS TO TRADE ARE HARMFUL

LBTs inhibit global economic growth, especially in innovative industries. They are harmful for three reasons. First, LBTs hurt the economies not using and affected by them, lowering their growth and often in turn encouraging LBTs in response. Second, LBTs damage the global economy, particularly by lowering the amount of innovation. Third, while LBTs are intended to benefit the countries that field them, in reality they can backfire and damage these countries' own economic growth.

LBTs Harm the Nations Affected by Them

LBTs injure the foreign enterprises affected by them. LBTs force these enterprises to produce in locations where they otherwise likely would not if the location production decision was made by purely economic factors alone. If it made economic sense to localize production in the destination country, enterprises would have already done so. Thus, coerced local production raises firms' costs, meaning lower profits and less investment in those enterprises' home nations, which limits firm growth, resulting in fewer jobs and lower profits, both at the enterprise and ultimately country level.

But LBTs also harm third-party nations. For example, China's extensive use of LBTs has distorted global trade and investment patterns and significantly harmed other developing nations, such as Brazil and India, which might have received some of the investment and gained some of the global market share. Not only has this meant slower economic growth in these third-party nations, more troublingly it has encouraged these nations to ramp up their own LBTs in response.

LBTs Harm the Global Economy

LBTs don't just harm particular economies; they hurt the global economy, particularly by leading to relatively less innovation produced by innovation-based industries, such as ICTs, life sciences, clean energy, and aerospace. Because innovative industries are characterized by relatively high fixed costs of initial R&D and design but relatively lower marginal costs of incremental production, innovation industries need access to large, global markets, which

enables them to cover their high fixed costs. But LBTs introduce market balkanization that limits scale economies. For example, a biopharmaceutical firm may only need a single plant to produce a drug for global distribution, but if nations require the firm to manufacture locally in order to sell locally, then it will need multiple plants, thus increasing the firm's costs, which both makes the drug unnecessarily more expensive for patients (globally) and reduces the resources available for reinvestment in future generations of innovation.

Second, LBTs introduce excess competition that can reduce innovation. Indeed, in some industries, too much competition can actually lead to reduced innovation. For example, China has used market-distorting LBTs such as forced technology transfer to help launch COMAC as a competitor to jet aircraft manufacturers Airbus and Boeing. But if these unfair policies allow COMAC to become successful, the result will be reduced revenues for Airbus and Boeing to invest in next-generation aviation innovation.

Third, weak IP protections compromise innovation by allowing competitors to obtain an innovator's IP at less than the fair market price, thus allowing them to siphon off sales that would otherwise go to innovators—and generate profits that could then be reinvested back into the next generation of innovative products. LBTs thus represent a perilous threat to the effective functioning of the global innovation economy.

LBTs Can Harm the Nations that Implement Them

Although LBTs appear as if they would benefit the countries that institute them, in reality, they can harm these economies. First, LBTs tend to raise the cost of key capital goods inputs, such as ICTs, which make a wide variety of industries using capital goods less productive and innovative. Second, LBTs damage countries' participation in global value chains for the production of high-technology products. Third, LBTs act often as a hidden tax on consumers and other businesses. Fourth, LBTs reduce the attractiveness of the nation as a location for foreign direct investment. Fifth, LBTs isolate countries from the global economy and tend not to achieve their intended effects in the manner countries desire. Finally, LBTs are harmful because they distract countries from implementing the right types of policies to grow their economies. For, in reality, using LBTs is a second-best option for countries—far better if their enterprises successfully compete and win in global markets on a best-value basis.

THE RIGHT GROWTH AND INNOVATION PATH

Instead of pursuing trade-distorting measures such as LBTs as part of an economic development strategy predicated on export-led growth, countries could achieve far more robust and sustainable economic growth if they embraced productivity and innovation-based economic development models. The foremost goal of such policies should be to boost productivity growth across-the-board in all industries, traded and non-traded alike. This is because the lion's share of economic growth for almost all nations comes not from changing the sectoral mix to higher-productivity industries, but from all industries and organizations, even low-productivity ones, boosting their productivity.

In order to truly maximize growth in the innovation-based global economy, nations would be better served by putting in place broad-based innovation and productivity policies along the lines of the economic growth policy pyramid depicted in Figure 2.



Figure 2: The Economic Growth Pyramid

At the base level are key framework conditions: factors such as the rule of law; effective government; a culture of trust; effective protection of property, including IP; and adequately competitive markets. The next level above these basic framework conditions includes an effective tax, trade, and regulatory environment, including both social (e.g., environmental) and economic (e.g., industry) regulations. These policies must be predictable and measured: tax rates that are too high or regulations that are too onerous can stifle growth. The next level above comprises key factor inputs including robust physical and digital infrastructures; a skilled workforce; and investment in knowledge creation. Yet even these are not enough to achieve success. Indeed, with more nations realizing that mastery of these three levels is what is needed just to “be in the game,” success requires going beyond this, to a fourth level, that includes effectively crafted innovation and productivity policies specifically tailored with regard to a countries’ competitive strengths and weaknesses. Policies in this category include R&D tax credits, specialized R&D institutes, support for regional innovation clusters, assistance programs for small and medium-sized businesses, and ICT policies such as e-health and e-government.

A STRATEGY FOR ROLLING BACK LBTs

Despite the fact that LBTs so often fail to achieve their intended aims and that superior alternative economic growth models exist, use of LBTs grows unchecked, and thus policy responses are needed. There are several steps that the WTO, affected countries, and the broader global economic community can take to combat LBTs:

- The WTO should take a stronger role in enforcing existing laws regarding local content requirements.

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- The WTO should extend its dispute settlement mechanism to cover other LBTs beyond local content requirements.
 - The WTO should establish a comprehensive database to track LBTs worldwide.
 - Nations committed to market-based trade should bring more cases addressing LBTs to the WTO.
 - All new bilateral and regional trade agreements should be constructed so as to fully eschew LBTs and other mercantilist practices (such as indigenous innovation).
 - The United States and the European Union should rescind a nation's participation in their Generalized Systems of Preferences program if the country has erected more than incidental localization barriers to trade (or other mercantilist practices).
 - The U.S. Congress should establish a 40 percent tax credit for all expenditures made by companies related to bringing such cases before the WTO. In addition, Congress should pass legislation allowing firms to obtain Department of Justice approval for anti-trust exemption to coordinate actions regarding technology transfer and investment to other nations that have installed LBTs.
 - National and international economic, trade, and development organizations, including the World Bank, International Monetary Fund, Overseas Private Investment Corporation (OPIC), Agency for International Development (AID), Millennium Challenge Corporation (MCC), Export-Import Bank, European Bank for Reconstruction and Development, and others, should both stop promoting export-led growth as a solution to development, and tie assistance to steps taken by developing nations to move away from LBTs—thereby rewarding countries whose policies are focused on spurring across-the-board productivity through non-mercantilist means.

In summary, LBTs not only represent a growing threat to the global economy but on net appear to be sub-optimal policies for even the nations employing them. Countries would be better served by employing a broad range of enterprise support-based innovation and competitiveness policies.