COLUMN:
DOMESTIC PRODUCTION AND TECHNOLOGY ACQUISITION

Preferential treatment for domestic products, such as local content requirements, is a classic means of promoting domestic industries and increasing production of domestic products. In recent years, there has been an increase in the number of measures which provide preferential treatment to domestic products in the context of the procurement by governments and their related departments. Such preferential treatment for domestic products is largely problematic in that it creates obstacles to foreign companies' trade and investment activities, and may also lead to the imposition of technology transfer in a manner contrary to the intentions of such companies. In this column, we introduce some notable developments related to domestic production and technology acquisition of several countries, and relevant international rules.

1. NEW MOVEMENT REGARDING DOMESTIC PRODUCTION

(1) CHINA

In China, preferential treatment is increasingly given to domestic products in procurement by the government and its related departments as well as through various industrial policies. Recently, it has been reported that China is developing a national standard which requires that office devices, such as multifunction machines and printers, and their core parts procured by government departments or critical information infrastructure operators are designed, developed, and produced in China.

(A) Amendment of the Government Procurement Act

See "Government Procurement" in Part 1, China.

(B) Preferential Treatment of Domestic Products by unpublished Internal Documents

See "Government Procurement" in Part 1, China.

(C) Preferential Use of Domestic Products in Government Procurement

Based on the Government Procurement Act enforced in 2003, the Government Procurement Imported Products Control Act[1] was enacted in 2007. Article 4 of the Act stipulates that "the government shall purchase domestic products, and when it is truly necessary to purchase imported products, shall review and control such products," and Article 8 stipulates that an application form and the opinions of at least five experts are required to review the procurement of imported products.

In accordance with this Act, some local governments in China, such as the provinces of Shaanxi; Yunnan, Kunming, Zhejiang; Hangzhou; and Anhui have issued notices that they would preferentially use domestic products in government procurement, except in unavoidable circumstances, and that application forms and expert opinions would be required when purchasing imported products[2].

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[1] Government Procurement Imported Products Control Act
http://www.gov.cn/ztzl/kjfzgh/content_883643.htm

[2] Local government notices
Shaanxi Province http://sxwjw.shaanxi.gov.cn/sy/ztzl/lszt/jjglnzt/gzdt_4836/202106/t20210615_2179397.html

(D) First Major Technical Equipment Popularization Application Guidance Catalogue

In 2016, the Ministry of Industry and Information Technology promulgated the "First Major Technical Equipment Popularization Application Guidance Catalogue"[3] with the aim of focusing on developing and promoting technological facilities that are lacking or nonexistent in domestic industries, and implementing the Chinese Manufacturing 2025. Companies certified for technical equipment listed in the Guidance Catalogue are eligible for preferential government procurement, as well as able to receive special benefits in the provision of fuel, electricity, and other infrastructure, licensing of intellectual property and financing, taxes, and insurance.

Some local governments have developed their own Guidance Catalogues based on the First Major Technical Equipment Popularization Application Guidance Catalogue of the central government. Among them, the First Major Technical Equipment Popularization Application Guidance Catalogue of Shenzhen City[4], Guangdong Province[5], states that products with a self-sufficiency rate (its own intellectual property or prices of domestic parts) of 70% or more will be included in the catalogue, and the sales price of those products will be subsidized by 30%.

In October 2021, the Ministry of Finance of China issued a notice on "achieving equal treatment of domestic and foreign firms in government procurement" and announced that domestic and foreign capital firms will be treated equally for products produced in China. However, according to the American Chamber of Commerce in China's white paper and other sources, a system called "安可 (Safety and Control)" or "信創 (Informatization Application Innovation)" was introduced in 2019. Under this system, only those listed in the list of recommended companies and products will be used for government procurement, and not only foreign imports but also local products made by foreign capital companies may be excluded from government procurement. See "Government Procurement" in Part 1, China.

(2) INDONESIA

Indonesia has traditionally been frequently imposing import restrictions and local content requirements to promote import substitution for specific products and specific industrial sectors. In recent years, in the area of public procurement, there has been a movement to designate the ratio of domestic production and give preferential treatment to a wide range of domestic products.

(A) Policy of Increased Use of Domestic Production (P3DN)

Since 2018, the Indonesian government has been implementing the Increased Use of Domestic Production (P3DN) policy based on the Government Ordinance No. 29 of 2018 on strengthening industrial competitiveness. Specifically, it calculates how many "Indonesian factors" are used based on production factors and costs, such as raw materials, labor, and manufacturing overhead costs (= a domestic production rate called TKDN), and requires proof of the domestic production rate for

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[3] The catalogue issued by the Ministry of Industry and Information Technology has since been revised. The latest version is the 2019 version of the catalogue promulgated in December 2019 [2019 version].
https://www.miit.gov.cn/jgsj/zbes/wjfb/art/2020/art_48540fba42264fc896b33e07491b863d.html

[4] Shenzhen First Major Technical Equipment Application Guidance Catalogue
http://gxj.sz.gov.cn/xxgk/xxgkml/qt/tzgg/content/post_10379774.html
In addition to local governments, the National Energy Administration has developed its own list of certifications in the field of energy.
http://www.nea.gov.cn/2021-12/22/c_1310388108.htm

[5] Guandong Province First Major Technical Equipment Application Guidance Catalogue
http://gdii.gd.gov.cn/jmwfg/content/post_3582384.html

government-procured products. For government-procured products, it is obligatory to use domestic products. If the ratio of domestic production meets 40%, such product is recognized as a domestic product. In addition to central and local governments, public entities such as national and public enterprises are also subject to such obligation.

(B) Local Content Requirements for Specific Products and Industries

In addition to procurement by the government and its related sectors, the Indonesian government has traditionally applied preferential treatment for national products to a variety of products as follows:

(i) Local content requirements and mandatory standards for LTE devices.

(ii) "Domestic content level" requirements for TVs, etc. (see above under "Trade-related Investment Treatment" in Part 1, ASEAN: Indonesia).

(iii) Requirement of the provision of domestic products and services by retailers (see "National Treatment Obligation" in Part 1, ASEAN: Indonesia).

(iv) Mandatory use of local labor and goods in the utilization of domestic mineral resources (see "Quantitative Restrictions" in Part 1, ASEAN: Indonesia).

(3) United States

See "Government Procurement" in Part 1, United States for rules relating to the US Buy American Act.

2. Related International Rules

In relation to existing international rules, two aspects of preferential treatment for domestic products as described above have become problematic: the local content and technology transfer requirements.

(1) Local Content Requirement

(A) WTO Agreement

(i) Various rules regarding the national treatment obligation

(1) Principle of national treatment obligation

In general, the preferential treatment of domestic products over imported products is likely to violate the national treatment obligation under GATT Article 3, Paragraph 4 and TRIMs Agreement Article 2, Paragraph 1. It could also be a violation of the national treatment obligation under GATS Article 17, Paragraph 1 in the case of measures affecting the provision of services. In addition, if the measure in question constitutes a technical regulation, this may amount to a violation of national treatment obligation under Article 2, Paragraph 1 of the TBT Agreement. Paragraph 2 of the said Article prohibits the drafting, establishment, and application of technical regulations that are more trade-restrictive than necessary to fulfill legitimate objectives.

(2) Exceptions to Government Procurement

On the other hand, the GATT, GATS, and TBT Agreement have exceptions for "procurement by governmental agencies" for "governmental purposes," although the wording of the articles differs

somewhat (GATT Article 3, Paragraph 8(a); GATS Article 13, Paragraph 1; TBT Agreement Article 1, Paragraph 4). The TRIMs Agreement also applies all GATT exceptions mutatis mutandis (Article 3 of the TRIMs Agreement). Therefore, in the case of these government procurement exceptions, the provisions of the above national treatment obligation do not apply. (Strictly speaking, Article 4 of the WTO Agreement on Government Procurement also stipulates a national treatment obligation, and measures to give preferential treatment to domestic products in government procurement run counter to the Article. However, the WTO Agreement on Government Procurement is not included in the single undertaking of WTO agreements, and only binds WTO members that have individually acceded to the said agreement. As illustrated in 1. above, China and Indonesia have not acceded to the said agreement as of the end of February 2023 (China is currently negotiating accession to the same)).

Therefore, the extension and range of these government procurement exceptions have become standing issues. There are few relevant precedents, but one precedent[6] has determined that government-procured products and imported goods that are allegedly discriminated against need to be in a competitive relationship in order for the matter to qualify for the exception in GATT Article 3, Paragraph 8(a). In the first MPIA-compliant arbitral award issued on July 25, 2022, it was stated that the entities that "purchase" the "products" referred to in the exception in GATT Article 3, Paragraph 8(a) were not limited to "governmental entities," but that the products had to be purchased for "procurement by governmental entities. [7]" There is no interpretation available on the scope of "governmental entities" as the source of "procurement." However, there are some case precedents[8] where the criteria for determining whether a procurement is "for government use" were established, such as whether there will be a loss in the long term.

The measures taken by China and Indonesia mentioned in 1. above apply not only to central and local governments but also to procurement by a wide range of entities involved in the public sector, such as critical infrastructure operators and state-owned enterprises. Therefore, it is likely that these measures are beyond the scope of the government procurement exception in GATT Article 3, Paragraph 8(a), for not fulfilling the requirements of "government use" and "procurement by governmental entities." In this regard, these measures may also conflict with the national treatment obligation under GATT Article 3, Paragraph 4 and may not be justified under the exceptions for government procurement.

(ii) The Agreement on Subsidies and Countervailing Duties

The Agreement on Subsidies and Countervailing Duties ("SCM Agreement") broadly regulates financial contributions by "governments or public entities" to specific enterprises or industries, that benefit their recipients. The rules of the SCM Agreement are separate from the provisions of the national treatment obligation (see GATT Article 3, Paragraph 8(b)) and are not subject to a government procurement exception.

If the preferential treatment of domestic products in government procurement has the effect of adding a price or reward paid for domestic products or services, it may be considered a subsidy that provides "benefit" to its recipient. If that is the case, depending on its design and purpose, such measure may have adverse trade effects on other members and be required to withdraw (Article 7.8 of the SCM Agreement) or be subject to countervailing treatments (Article 10 through 23 of the SCM Agreement). In addition,

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[6] Appellate Body Report, CANADA – CERTAIN MEASURES AFFECTING THE RENEWABLE ENERGY GENERATION SECTOR (DS412)/
CANADA – MEASURES RELATING TO THE FEED-IN TARIFF PROGRAM (DS426)

[7] MPIA Arbitral Award, COLOMBIA – ANTI-DUMPING DUTIES ON FROZEN FRIES (DS591)

[8] Appellate Body Report, CANADA – CERTAIN MEASURES AFFECTING THE RENEWABLE ENERGY GENERATION SECTOR (DS412)/ CANADA – MEASURES RELATING TO THE FEED-IN TARIFF PROGRAM (DS426)

as in the case of regulations such as those in China mentioned in 1. above, when a regulation requires a wide range of trading entities beyond the limits of government agencies in "procuring" domestic products, tax benefits and refunds may be provided to such "procuring" entities in return for compliance. In this case, if the entity conducting the "procurement" is not a public entity, such tax benefits or refunds may instead be understood to be a subsidy granted for the purchase of domestic goods by market participants. Such subsidies are subject to uniform prohibition as so-called local content subsidies (Article 3, Paragraph 1(b) of the Agreement on Subsidies) (Article 3.2 and Article 4.7 of the Agreement).

(iii) China Accession Protocol (Rules specific to China)

In the case of China, Article 7, Paragraph 3 of the China Accession Protocol separately prohibits the requirement of the use of domestic products through laws, regulations, and other measures. Unlike the GATT, GATS, TRIMs and TBT Agreement, the China Accession Protocol does not contain any exceptions for government procurement. There is no precedent for determining whether the GATT government procurement exception applies to the China Accession Protocol, but there has been a dispute over whether the GATT general exception (GATT Article 20) could apply to the China Accession Protocol. In one precedent, the decision was based on whether the specific wording of the article contemplated the application of GATT Article 20[9]. If the relationship between China's preferential treatment of domestic products and Article 7, Paragraph 3 of the Accession Protocol is disputed in a WTO dispute settlement procedure, it is highly likely that the issue will be whether the wording of Article 7, Paragraph 3 contemplates the application of Article 3, Paragraph 8(a) of the GATT.

(B) Economic Partnership Agreement (Investment Chapter) and Investment Agreement

Preferential treatment for domestic products, such as those described in 1. above, may also violate the disciplines of the Investment Agreements and the Investment Chapter of the Economic Partnership Agreements (hereinafter collectively referred to as the "Investment Related Agreements") that Japan has concluded. Specifically, the compatibility between such preferential treatment and the following rules is at issue. For details, see the column on "Criteria for consistency with agreements of local content requirements" in the 2021 Report on Compliance by Major Trading Partners with Trade Agreements –WTO, EPA/FTA, and IIAs–.

(i) Prohibition of Performance Requirements

Many of the Investment Related Agreements that Japan has concluded include provisions that prohibit the host State from requiring investors to conduct specific actions in connection with their investment activities (i.e., provisions prohibiting performance requirements). Some of these provisions prohibit local content requirements. For example, if a party requires that its own domestic products be purchased or used in preference to the imported products in connection with the investment activities of investors from another party, such requirement may violate the prohibition of performance requirements. However, it should be noted that the so-called "liberalization-type" Investment Related Agreements often contain provisions that make government procurement an exception from the prohibition of performance requirements.

(ii) National Treatment Obligation

[9] See "Justification" in Part II.

Many of the Investment Related Agreements that Japan has concluded have rules that prohibit providing less [favorable/favourable] treatment to foreign investors or their investments compared to host State's domestic investors or their investments in like circumstances (national treatment obligation). If Japanese investors who make investments in another party are treated less [favorable/favourable] than that party's investors because of that party's preferential treatment of domestic products, there is a possibility that such party's action would violate the national treatment obligation. However, it should also be noted that many "liberalization type" Investment Related Agreements provide for exceptions to the national treatment obligation for government procurement.

(iii) Obligation of Fair and Equitable Treatment

The obligation of fair and equitable treatment obliges host States to provide a certain level of treatment to foreign investors, and this obligation is stipulated in many of the Investment Related Agreements concluded by Japan. While the national treatment and most-[favored/favoured]-nation treatment depend on how a host State treats other investors, the obligation of fair and equitable treatment stipulates an absolute standard of treatment (therefore, even measures with no discrimination between domestic and foreign investors can still constitute a violation of the obligation). The specific content of the obligation is determined based on the factors, such as the object and purpose of each Investment-Related Agreement, the wording and context of the relevant provisions, and individual specific circumstances. Therefore, although the preferential treatment of domestic products does not necessarily constitute a violation of the fair and equitable treatment obligation, there would still be a possibility of such violation depending on the case; for example, where the investor is required to use domestic products in preference to imported products after the investment, and such a requirement is contrary to the "legitimate expectation" arising from certain representations given by the host State at the time of the investment.

(2) Technology Transfer Requirement

Preferential treatment for domestic products could force foreign firms to produce locally, increasing the risk of technology leakage to local firms and governments. From this point of view, preferential treatment of domestic products may also conflict with the rules governing technology transfer requirements.

Under the current WTO and Investment Related Agreements, the rules on technology transfer are as follows.

(A) WTO Agreement

The China Accession Protocol additionally commits to ensure that the government's distribution of approval to import goods and rights to investment is not conditioned on technology transfer (Article 7, Paragraph 3 of the China Accession Protocol).

(B) Investment Related Agreements

Among the Investment Related Agreements to which Japan is a party, many of those that have been concluded in recent years, such as the CPTPP, the Japan-UK EPA, and the RCEP, prohibit forced technology transfer in connection with investment activities. In addition, the Japan-China-Korea Trilateral Investment Agreement contains a provision of the Performance Requirements with regard to transfer of technology, although it is subject to the condition that such treatments cannot be

"unreasonable or discriminatory." Moreover, although it is an agreement between third countries, the so-called Phase One agreement between the US and China prohibits the forced technology transfer as a stand-alone element and not only as a condition for investment.

3. CHALLENGES

As mentioned above, preferential treatment for domestic products in government procurement and related public sector procurement in recent years is likely to violate existing international rules, but at the same time, attention should be paid to the challenges and limitations of existing international rules. Firstly, national treatment obligations under the WTO agreements include exceptions for government procurement, and their scopes and external boundaries are not always clear. In addition, the WTO Agreement on Government Procurement, which directly governs government procurement-related measures excluded by the exception rule, is not subject to single undertaking by the WTO members. Thus, unless a WTO member voluntarily accedes, it will not be subject to national treatment or other obligations under the agreement. Furthermore, while there are rules regarding subsidies in the SCM Agreement, there are high barriers to proving the factors confirming the existence of subsidies, such as whether "benefit" is conferred to the recipient.

Furthermore, the prohibition on performance requirements, the national treatment obligation, and the fair and equitable treatment obligation under the Investment Related Agreements can be invoked only when certain requirements are met (in relation to investment activities, the imposition of requirements to purchase or use domestic products, treatment that is less favorable than that of investors in the host State, and actions that are contrary to legitimate expectations, etc.). There are still many unknowns regarding how to invoke these provisions against the countries accepting investments and how to encourage the abolishment or improvement of such measures (the length of time required for dispute resolution procedures is long, decisions are not very predictable, many Investment Related Agreements limit the matters that can be determined by the arbitral tribunal to financial compensation, etc.).

As a response to the above issues, it is necessary as a matter of course to collect information on individual systems and treatments and their practical impact, and to build up sufficient evidence to claim violations under the current rules. For example, in relation to the rules on technology transfer requirements, it is essential to collect specific and concrete evidence on whether being effectively forced to transfer technology is actually equivalent to coercion of technology transfer, which is prohibited under the China Accession Protocol and Investment Related Agreements.

At the same time, it is also important to raise issues at the WTO committees and the relevant fora on investment-related agreements, and to urge strict compliance with existing international rules. The government of Japan has, for example, expressed its concern at the WTO committee about China's draft national standard and Indonesia's local content requirements described in 1. above.

Furthermore, in addition to these efforts, it is also important to consider and explore the possibility of making active use of international fora between multiple countries and creating new norms for areas where existing international rules are insufficient. In particular, the need to strengthen existing international rules on forced technology transfer has also been mentioned in several ministerial statements. For example, the G7 Trade Ministers' Statement issued on September 15, 2022 stated "we will sustain and further step up our efforts to work toward a level playing field through more effective use of existing tools, as well as developing appropriate new tools and stronger international rules and norms on nonmarket policies and practices" and raised "all forms of forced technology transfer" as one example of the concerns shared by the G7 Trade Ministers.