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Indonesia's Local Content Requirements: Assessment with WTO Rules

Michelle LIMENTA
Universitas Pelita Harapan

Lili Yan ING
Economic Research Institute of ASEAN and East Asia (ERIA)

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Abstract*:* *Local content requirement is one of the policy measures used by many countries around the globe, including Indonesia, to protect and support their strategic sectors. This paper assesses Indonesia's local content regulations in the energy, telecommunication devices, pharmaceutical, and modern retail sectors that are deemed problematic by certain Word Trade Organization (WTO) Members in light of Indonesia's obligations under the multilateral trade rules.*

Keywords: WTO, Indonesia, LCRs, Protection

JEL Classification: F1, F13

‘Localisation’ has been around for many years, promoted and adopted by developed and developing countries. The instrument, however, can turn into a trade barrier when used to protect domestic industries at the expense of foreign competitors (Stone, Messent, and Flaig; 2015).

The fastest-growing and widely used ‘localisation’ instrument is local content requirements (LCRs). In general terms, the LCRs have been associated with (i) policy instruments employed by government; (ii) in the form of non-tariff measures; and (iii) aiming to support and incentivise the use of local goods, services, and labour.

The proponents of local content policies view that the LCRs promote development by increasing local production and creating jobs, protecting undeveloped domestic infant industries, and encouraging technology transfer from foreign to local entities (Ramdoo, 2015). In contrast, the opponents argue that the LCRs force companies to use local inputs and restrict their access to global markets. By limiting the sources of inputs, the LCRs increase production costs, eventually transferring higher costs and prices to the consumers, producing economic inefficiency, and discouraging foreign investors from investing in a country (Johnson, 2021).

Despite these concerns, many governments around the globe find the LCRs a politically appealing and favourable instrument to incentivise the growth of their local industries. Some examples of these LCR measures are (i) ‘Buy American’ and ‘Made-in-America’ executive orders by the current United States (US) President Biden administration (White House, 2021); (ii) ‘buy local’ rules in the Canadian province of Ontario’s Green Energy Act;[1] and (iii) China’s measures requiring local content on the information and communication technology equipment used by the banking sector (Committee on TRIMs, 2015).

Indonesia’s ‘localisation’ strategy was pursued in the past under several initiatives such as the ‘Benteng Program’ (1950–1957), ‘Deletion Program’ (1974–1993), and ‘National Car Program’ (1996) (Negara, 2016). But these programs were unsuccessful and eventually terminated. In 2009, the former President Susilo Bambang Yudhoyono’s administration revisited the ‘local content’ strategy by initiating the ‘Increased Use of Domestic Production’ (*Peningkatan Penggunaan Produksi Dalam Negeri,* or P3DN)

[1] The Government of Ontario, Green Energy and Green Economy Act 2009, S.O.2009, c. 12 – Bill 150, received Royal Assent on 14 May 2009.

program through the signing of Presidential Instruction No. 2 of 2009 concerning Utilisation of Domestic Products in Government Procurement of Goods and/or Services. The program urges the relevant government institutions and agencies to utilise and use domestic goods and services in government procurement projects. The P3DN program is reflected in the subsequent laws and regulations, such as Law No. 3 of 2014 concerning Industrial Affairs (Industrial Affairs Law) and Government Regulation Number 29 of 2018 concerning Industrial Empowerment (GR 29/2018).

The Industrial Affairs Law under Articles 85–86, for example, requires the use of domestic products in goods and services procured by (i) government institutions, where the project finance is derived from state or regional budgets, including domestic or foreign loans or grants; and (ii) state-owned, regionally owned, and private enterprises, where the project finance is from the state or regional budgets and work activities are conducted under the framework of public–private partnership. The Industrial Affairs Law also encourages the Indonesian government to provide incentives in the form of price preferences and administrative flexibilities to support the utilisation of domestic products in public procurement.[2]

GR 29/2018 was issued on 13 July 2018 as the implementing regulation to the Industrial Affairs Law. The regulation mandates the use of domestic products in public procurement, both at the planning and implementation stages, implemented according to the minimum level of domestic component (*Tingkat Kandungan Dalam Negeri*, or TKDN, i.e., the use of domestic components in goods, services, and/or combination thereof) prescribed by the regulation.[3]

While the general calculation method of TKDN can be found in Minister of Industry Regulation No. 16/M-IND/PER/2/2011, Indonesia's Ministry of Industry also issued a specific TKDN calculation for several 'strategic' products, including solar power plants, electronics devices (e.g. telematics, mobile phones, and computer tablets), and pharmaceutical raw materials.

Under the multilateral trade rules, any measures imposed by World Trade Organization (WTO) members that discriminate against foreign products or lead to quantitative restrictions could violate WTO rules. The WTO's Agreement on Trade

[2] Law No. 3/2014, Art 88.
[3] GR 29/2018, Arts 57–58, and 61.

Related Investment Measures (TRIMs) lists measures, including LCRs, that are inconsistent with Article III (national treatment of imported products) or Article XI (prohibition of quantitative restrictions on imports or exports) of the General Agreement on Tariff and Trade 1994 (GATT).[4] The TRIMs Committee is responsible for monitoring the operation and implementation of the Agreement, and WTO members can consult the matters in the TRIMs Committee meeting.[5] In the past few years, several WTO members in the TRIMs Committee meeting continuously raised their concerns over Indonesia's LCR measures in various sectors such as energy, telecommunications, pharmaceutical, and retail.

This paper aims to explore Indonesia's LCR measures that have been questioned at the multilateral trade forum and assess their compliance in light of the country's international trade obligations under the WTO. Following this introduction, the paper is divided into three further sections. Section 1 looks at Indonesia's local content measures in specific sectors that have drawn concern in the WTO. Section 2 examines whether these LCR measures are consistent with WTO rules. Finally, Section 3 provides conclusions and recommendations.

1. Let's Go Local – Indonesia's Local Content Laws and Policies in the Energy, Telecommunication Devices, Pharmaceutical, and Modern Retail Sectors

Over the years, several WTO members have been voicing their concerns over Indonesia's measures prioritising the use of domestic products in multiple areas – raising the issue of consistency of such measures with WTO law (WTO, 2020). At the Committee on TRIMs meeting on 15 September 2020, for instance, the US reiterated its concern about Indonesia's use of localisation requirements in various sectors, such as telecommunications, mobile technology, energy, agriculture, retail, and franchising. The US also pointed out Indonesia's adoption and implementation of LCRs for 4G LTE mobile devices and base stations as a long-standing issue that WTO members had questioned for several years (Committee on TRIMs, 2020).

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[4] WTO, 'Agreement on Trade Related Investment Measures'.
[5] Ibid.

Supporting the statements made by the US, the European Union (EU) raised the issue with the imposition of local content percentage for pharmaceutical products, where according to the bloc, the requirement is worrisome considering Indonesia imports over 95% of active pharmaceutical ingredients (Committee on TRIMs, 2020, para 14). Japan and Australia also voiced a similar concern, particularly with respect to LCRs for 4G LTE mobile devices, local processing requirements in the energy sector, and LCRs in the retail sector, as well as questioned their compatibility with WTO rules (Committee on TRIMs, 2020, paras 19–30).

In defence, Indonesia argued that the measures were taken to facilitate foreign investment, which was beginning to bear positive results and in an upward trajectory. Indonesia also claimed that TKDN measures operate voluntarily or applied for government procurement, and they are a manifestation of the government maintaining inclusivity of economic development (Committee on TRIMs, 2019, para 31).[6]

The following sections look at Indonesia's local content measures that have raised trade concerns in the WTO in the energy, telecommunication devices, pharmaceutical products, and modern retail sectors.

A. Energy sector

Since 2009, Indonesia has required the contractors engaged in energy supply projects to source a proportion of their components locally to support the domestic manufacturing industry. That year, the Executive Agency for Upstream Oil and Gas (Badan Pelaksana Kegiatan Usaha Hulu Minyak dan Gas Bumi or BP Migas), today named the Upstream Oil and Gas Regulatory Special Task Force (Satuan Kerja Khusus Pelaksana Kegiatan Usaha Hulu Minyak dan Gas Bumi or SKK Migas), set at least 50% of oil and gas projects to utilise local goods and services to ensure local businesses benefit from the oil and gas contractors' expenditure (Ministry of Energy and Minerals, 2009).

Since then, the government has issued numerous regulations detailing more stringent domestic content requirements and extending the scope to cover energy-related sectors other than oil and gas. The following sub-sections discuss the regulations issued

[6] See also Committee on TRIMs (2019), para 29.

to encourage the increased use of domestic products in specific energy sectors*:* (i) electricity infrastructure, (ii) upstream oil and gas, and (iii) crude oil.

1. Electricity infrastructure

To increase the utilisation of domestic goods and services in the electricity power sector, the Minister of Industry on 21 March 2012 issued Regulation No. 54/M-IND/PER/3/2012 concerning Guidelines for the Utilisation of Domestic Products for the Development of Electric Power Infrastructure (MOI Regulation No. 54/2012). Business entities (state-owned and regionally owned enterprises, and private business entities or cooperatives) constructed and developed electricity infrastructure for public purposes using the state's revenue/budget, regional budget, grants, or foreign loans must meet the LCRs specified in the regulation.[7] The exception applies under the following conditions: (i) the goods cannot be produced domestically, (ii) the technical specification of the domestic goods does not meet the stated requirements, and/or (iii) when the local goods cannot meet the demand.

The minimum level of local content under MOI Regulation No. 54/2012 is distinguished based on (i) the power sources (e.g. steam, hydro, geothermal, gas, and solar) and (ii) power plant capacity (in megawatt or per block), with more flexibility provided for business entities undertaking larger capacity projects.[8] MOI Regulation No. 54/2012 also specifies the components of goods and services for each type of power plant.

Regarding electricity produced from renewable energy sources, Minister of Energy and Mineral Resources Regulation No. 4 of 2020 concerning Second Amendment to Minister of Energy and Mineral Resources Regulation No. 50 of 2017 concerning Utilisation of Renewable Energy Resources for the Supply of Electricity state that in selecting a power plant developer (i.e. power supply business entity cooperating with Indonesia's electricity state-owned enterprise, PT Perusahaan Listrik Negara (PLN) under a power grid sale and purchase agreement), PT PLN must prioritise the developer that satisfies the required level of local content value.[9]

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[7] MOI Regulation No. 54/2012, Art 2.
[8] Ibid., Arts 5–13.
[9] MEMR Regulation No. 4/2020, Art 15.

2. Upstream oil and gas

Several provisions in Indonesia's Law No. 22 of 2001 concerning Oil and Natural Gas (Oil and Gas Law) call for 'localisation' in oil- and gas-related activities to improve domestic capacity and competitiveness.[10] To implement the Oil and Gas Law provisions for the LCRs in the upstream oil and gas operation, the Minister of Energy and Mineral Resources issued Regulation No. 15 of 2013 concerning Utilisation of Domestic Products in the Upstream Oil and Gas Business Activities (MEMR Regulation No. 15/2013). Article 4, in particular, requires every contractor, local producer, and supplier of goods and services that procures goods and services in the upstream oil and gas operations to utilise, optimise, and empower the use of domestic goods and services.

The TKDN targets for goods (e.g. pumping unit, machinery, and equipment) and services (e.g. survey, seismic, and geological studies) to be complied by the upstream oil and gas contractors are specified in Appendix I of MEMR Regulation No. 15/2013, which are divided into short-term (2013–2016), medium-term (2017–2020), and long-term (2021–2025) periods.[11] Moreover, Appendixes II, III, and IV of the regulation provide a more detailed method of TKDN calculation of goods and services.

Essentially, SKK Migas will set the target of local content in each work and budget plan and/or in the list of procurement plan, which the contractors must refer to in procuring goods and services.[12] For instance, SKK Migas reported in January 2021 that they had completed the 2021 procurement list covering 1,482 tender packages with the total amount of US$6 billion and a minimum target of 57% of the local content value (SKK Migas, 2021).

Therefore, the contractors must ensure that domestic producers and suppliers of goods and services meet the local content level commitment stipulated in the procurement contract.[13] The government also offers price preference in government procurement as an incentive, provided that the local content level reaches at least 25% for goods and 30% for services.[14] A 2.5% in price preference is also added to business entities that retain the status of 'local' company.

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[10] Law No. 22/2001., Arts 3(d), 11(3)(o), 40(4), and 42(h).
[11] MEMR Regulation No. 15/2013, Appendix I.
[12] Ibid., Arts 6–7.
[13] MEMR Regulation No. 15/2013, Art 8.
[14] Ibid., Art 9.

Pursuant to MEMR Regulation No. 15/2013, the Minister of Energy and Mineral Resources will award contractors, domestic producers, and suppliers of goods and services for utilising domestic products in upstream oil and gas business activities.[15] However, the contractors are also subject to sanctions from SKK Migas for non-compliance with their TKDN obligations. Meanwhile, the producers and suppliers will face administrative sanctions from the Head of the Directorate General of Oil and Gas under the Ministry of Mineral and Energy Resources.

3. Crude oil

The Minister of Energy and Mineral Resources issued Regulation No. 42 of 2018 concerning Priorities for the Utilisation of Crude Oil to Meet Domestic Needs (MEMR Regulation No. 42/2018) on 5 September 2018 to optimise the use of local crude oil and improve the country's energy security. The regulation mandates state-owned oil-and-gas company, Pertamina, and crude oil–processing licence holders, to prioritise the utilisation of domestic crude oil supplied by domestic contractors before import.[16]

In general terms, Article 3 of the regulation requires contractors or their affiliates to offer a portion of crude oil to Pertamina and/or crude oil–processing licence holders at least 3 months before the start of the period of export recommendation for crude oil obtained by the contractors. Pertamina or crude oil businesses should undertake negotiations concerning the purchase of the contractor's portion of crude oil under the 'arm's length' business principle.[17]

Nevertheless, during their meeting with Indonesian Parliament Members in September 2020, Pertamina representatives expressed their concern on MEMR Regulation No. 42/2018, as they are obligated to purchase domestic crude oil at a higher rate, while the world price of crude oil is low (DP-RI, 2020).

[15] Ibid., Art 20. The awards are divided into three categories: gold (very good), silver (good), and bronze (fairly good). See also Arts 21–22 regarding sanctions.
[16] MEMR Regulation No. 42/2018, Art 3.
[17] Ibid., Art 4(2).

B. Telecommunication devices

Minister of Communication and Informatics Regulation No. 27 of 2015 concerning the Technical Requirements for Long-Term Evolution Technology Standard Based Telecommunication Tool and Equipment (MOCI Regulation No. 27/2015) was issued on 7 July 2015 as a part of Indonesia's broader plan to move up the value chain of manufactured products and to integrate the country's position into the global supply chain (WTO TRIMs, 2015).

Article 4 of MOCI Regulation No. 27/2015 provides explicitly for the LCRs for the base station (i.e. instrument providing connectivity to subscriber station such as network, antenna, and so forth) and subscriber station (i.e. any communication devices on the consumer side such as smartphones, modems, laptops, and tablets). The local content threshold was set at 30% for the base station and 20% for the subscriber station in 2015; it was increased to 40% for the base station and 30% for the subscriber station in 2017. Furthermore, the TKDN threshold for 4G and 5G subscriber stations is set to increase again from 30% to 35% through the issuance of MOCI Regulation No. 13 of 2021 on 12 October 2021. The increased local content threshold in 4G- and 5G-based telecommunication devices aims to support the domestic telecommunication industry (Kominfo, 2021).

Specific TKDN calculation methods for particular LTE-based telecommunication devices are found in various regulations issued by the Minister of Industry. An example is Ministry of Industry Regulation No. 29/M-IND/PER/7/2017 concerning Provisions and Procedures to Calculate Domestic Component Levels for Mobile Phones, Handheld Devices, and Tablet Computers (MOI Regulation No. 29/2017). Under this regulation, the calculation of TKDN for mobile phones, handheld devices, and tablet computers covers three main aspects: (i) manufacture (e.g. material, labour, machinery); (ii) development (e.g. licence, firmware, and industrial design); and (iii) applications (e.g. design, intellectual property, competency certificate), with the proportion of 70%, 20%, and 10%, respectively.[18] MOI Regulation No. 29/2017 also provides a scheme to calculate the TKDN value for investment-based innovative development, as provided in Articles 35–56 thereof.

[18] MOI Regulation No. 29/2017, Art 4.

Another example is Minister of Industry Regulation No. 22 of 2020 concerning Provisions and Procedures for Calculations of Domestic Component Level Values for Electronic and Telematics Products. Under this regulation, the composition of TKDN for digital products is 70% for manufacturing and 30% for development. Meanwhile, the proportion for non-digital products is 80% and 20%, respectively.[19]

C. Pharmaceutical products

President Joko 'Jokowi' Widodo has called for a reform of the country's pharmaceutical and medical devices industry, highlighting that nearly 90% of the raw materials for the pharmaceutical industries particularly the active pharmaceutical ingredients (APIs) are imported which contributed to the country's trade deficit and hindered the growth of the local pharmaceutical industry (Cabinet Secretariat of the Republic of Indonesia, 2020).

In the past few years, the government had tried to develop the domestic upstream pharmaceutical industry and reduce import dependence on raw materials. During President Jokowi's first term, the administration unveiled the 11th economic stimulus package, where the government sought to boost the local production of medicines' raw materials, particularly for biotechnology, vaccines, herbal extracts, APIs, and medical devices. In line with the economic stimulus, the government issued Presidential Directive No. 6 of 2016 concerning the Acceleration of the Development of the Pharmaceutical and Medical Equipment Industry (PD No. 6/2016). The directive mandated the Minister of Health to prioritise domestic pharmaceutical products and medical devices through e-tendering and e-purchasing.[20] At the same time, the Minister of Industry was mandated to monitor and evaluate the implementation of local content value in the field of pharmaceutical and medical devices.

In response to PD No. 6/2016, the Minister of Health issued Regulation No. 17 of 2017 concerning the Action Plan for the Development of the Pharmaceutical and Medical Equipment Industry (MOH Regulation No. 17/2017) in February 2017. It put forward the strategy and action plan to build a robust and research-oriented upstream pharmaceutical

[19] MOI Regulation No. 22/2020, Arts 5, 12.
[20] Presidential Directive No. 6 Year 2016. Point (3).

and medical devices industry that could eventually produce export-oriented pharmaceutical raw materials.[21]

To align with PD No. 6/2016 and MOH Regulation No. 17/17, the Minister of Industry issued Regulation No. 16 of 2020 concerning Provisions and Procedures for the Calculation of Local Component Level for Pharmaceutical Products (MOI Regulation No. 16/2020) on 29 May 2020. The regulation provides for a detailed local content calculation formula for pharmaceutical products based on their raw materials (50%), research and development (30%), manufacturing (15%), and packaging (5%).[22] Article 4 provides for the components and the calculation method of local content value for pharmaceutical products. APIs, for example, comprise 65% of the component of raw materials.

It is worth noting that MOI Regulation No. 16/2020 does not provide any sanctions for the failure of obtaining the TKDN certificate. Presently, the requirements of local content value calculation and certificate are linked to certain benefits obtained in the government procurement process. And according to the government's statement in the 2019 TRIMs Committee meeting, the government has no intention to extend the imposition of LCRs for pharmaceutical products and medical devices beyond government procurement (Committee on TRIMs, 2019, para 35).

D. Modern retail

Indonesia is a promising market for fast-moving consumer goods due to its robust economic development and favourable demographics (large population and growing urban middle class with strong purchasing power). Unsurprisingly, the country was ranked fifth globally for its retail investment attractiveness in AT Kearney's 2019 Global Retail Development Index (Kearney, 2019).

Against this background, the government and the retail business association had voiced their concern about the high percentage of imported products sold at the domestic retail market (Kementerian Perindustrian, 2014). To address this issue, the Minister of Trade issued Regulation No. 70/M-DAG/PER/12/2013 concerning Guidelines for

[21] MOH Regulation No. 17/17, Art 3 and Chap 2 of Annex I.
[22] Ibid., Art 2.

Organizing and Developing Traditional Markets, Shopping Centres and Modern Stores (MOT Regulation No. 70/2013) on 12 December 2013.

A salient provision introduced by the regulation is a local sourcing requirement, which mandates modern stores to prioritise the supply of local goods produced by micro, small, and medium-sized enterprises.[23] In addition, shopping centres and modern stores must ensure that 80% of the sale or inventory products (i.e. the store's entire stock keeping unit) are domestically produced products.[24] Flexibility in the form of waiver to the local sourcing requirement is provided under paragraph 2 of Article 22, which requires shopping centres and modern stores to obtain the minister's approval and a recommendation from the Communication Forum for Arrangement and Development of Traditional Market, Shopping Centre, and Modern Store to benefit from the waiver.

But the communication forum's recommendation is now no longer required under Ministry of Trade Regulation No. 56/M-DAG/PER/9/2014 concerning the Amendment to MOT Regulation No. 70/M-DAG/PER/12/2013 (MOT Regulation No. 56/2014). Moreover, self-service stores, such as stand-alone brand and specialty stores, are qualified for the waiver as long as they satisfy the following requirements:

- The manufactured goods require uniformity of production and are part of the global supply chain.
- The goods carry a globally renowned brand or mark (premium products) and have no production base in Indonesia.
- The goods originate from certain countries to meet the demands of its citizens that reside or live in Indonesia.

Despite this waiver eligibility, the relevant modern stores must progressively increase the sale of similar goods produced domestically and report the implementation to the Director General of Foreign Trade within the Ministry of Trade.[25] Modern stores and shopping malls that have not met the required 80% local products inventory must adjust its inventory within 2 years after the amended regulation comes into effect.[26]

[23] MOT Regulation No. 70/2013, Art 17.
[24] Ibid., Art 22. Shopping centre and modern market are defined in Article 1(6) thereof.
[25] MOT Regulation No. 56/2014, Art 22 (3).
[26] Ibid., Art 41 (5).

2. Taming LCRs – Consistency of Indonesia's Local Content Measures vis-à-vis WTO Agreements

As mentioned in section 1, the LCRs could lean towards protectionism when their application hinders international trade and investment by reducing domestic and international competition, economic diversification, and innovation. Still, the LCR is a common industrial policy widely adopted by WTO members, including Indonesia. In fact, the first case against Indonesia in a WTO dispute settlement concerned LCRs in the automobile industry, where the WTO panel found Indonesia's 'localisation' measures to violate Article 2.1 of the TRIMs Agreement (WTO, 2021).

As described in section 2, Indonesia's LCR measures in electricity infrastructure, upstream oil and gas, and pharmaceutical sectors are related to the advantages conditioned to using local goods and services in government procurement. Meanwhile, the 'localisation' measures for crude oil, telecommunications, and modern retail are tied to the 'market access' advantage granted as the benefit of using local components and local sourcing.

This section evaluates the WTO compatibility of Indonesia's LCR measures elaborated on in section 2. While the requirement to prioritise the use of domestic goods and services is generally prohibited under WTO rules, there is, however, an 'exemption' for government procurement meeting certain criteria (explained below) provided in Article III: 8(a) of GATT. The growing awareness of the trade-restrictive nature and effects of discriminatory procurement policies resulted in the conclusion of the Government Procurement Agreement (GPA), a plurilateral agreement included in Annex 4 to the Marrakesh Agreement Establishing the WTO. The GPA was revised and entered into force on 6 April 2014. However, Indonesia is not yet a party to the revised GPA; thus, the obligations under the Agreement do not apply to the country. For this reason, this paper does not conduct the assessment under the GPA.

It is also worth noting that almost all the claims concerning LCRs challenged in the WTO dispute settlement were brought under WTO rules relevant to trade in goods (as can be seen in Annex I). For space and efficiency reasons, the assessment under the General Agreement on Trade in Services (GATS) is not included in this paper.

A. Trade-related investment measures

Article 2.1 of the TRIMs Agreement prohibits WTO members from imposing any investment measures related to trade in goods (TRIMs) inconsistent with Articles III and XI of GATT. Moreover, Article 2.2 of the TRIMs Agreement refers to an illustrative list of violations annexed to it. Paragraph 1(a) of the Illustrative List covers 'local content' TRIMs, which requires the purchase or use by an enterprise of products of domestic origin or source (LCR). Whereas paragraph 1(b) covers 'trade-balancing' TRIMs, limiting an enterprise's purchases or use of imported products to an amount related to the volume or value of local products it exports.[27]

It is clear under Article 2.1 of the TRIMs Agreement that any investment measures or requirements imposed on investors to allow them to invest or operate in the host country fall within the scrutiny of GATT Articles III and XI. Moreover, Article 2.2 explains that if such measures fall within the coverage of paragraph 1(a) of the Illustrative List, they are automatically inconsistent with the correlating GATT provision (Hestermeyer and Nielsen, 2014). This understanding was confirmed in WTO case law. The panel in *Canada – Renewable Energy* (also cited in the Panel Report, *India – Solar Cells*) stated that:[28]

> Article 2.2 of the TRIMs Agreement does not impose any obligations on Members, but rather informs the interpretation of the prohibition set out in Article 2.1. In particular, Article 2.2 explains that the TRIMs described in the Illustrative List of the Annex to the TRIMs Agreement are to be considered inconsistent with Members' specific obligations under Articles III:4 and XI:1 of the GATT 1994.

Furthermore, the panel in *Indonesia – Auto* underlined that the wording of the Illustrative List makes it clear that a simple advantage conditional on the use of domestic goods is inconsistent with TRIMs Article 2 even if the LCR is not binding as such.[29] These provisions and practices suggest that if Indonesia's local content policy in 4G LTE–based telecommunication devices and modern retail sector is challenged in WTO dispute

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[27] WTO, 'Agreement on Trade Related Investment Measures, https://www.wto.org/english/tratop_e/invest_e/invest_info_e.htm (accessed 8 March 2021).
[28] Panel Report (2012) *Canada – Renewable Energy*; See also Panel Report (2016) *India – Solar Cells*.)
[29] Panel Report (1999) *Indonesia – Auto*, para 14.90.

settlement, they would potentially be found inconsistent with the TRIMs Agreement as their LCR element falls within the coverage of paragraph 1(a) of the Illustrative List.

The question is whether the LCRs in telecommunication devices and modern retail are 'investment measures' and 'related to trade in goods'. The TRIMs Agreement does not define trade-related investment measures (TRIMs). However, in the WTO relevant case law, the measures in question are considered TRIMs because (i) their objective is to encourage investment in local production and (ii) they affect trade by favouring domestic products over imported products.[30] The panel in *Indonesia – Auto* noted that the TRIMs Agreement is not concerned with the regulation of foreign investment. The panel also dismissed the claim that internal measures (i.e. internal taxes or subsidies) are not TRIMs. This is because the TRIMs Agreement is concerned with LCRs, compliance with which may be encouraged by providing any types of advantage, such as in the form of internal taxes advantages and subsidies (Panel Report, 1999, para 14.73). Thus, the term 'TRIMs' is broad in scope. In this respect, Indonesia's local content measures in 4G LTE–based telecommunication devices and the modern retail sector will likely be considered trade-related investment measures.

Moreover, even if the LCRs in these two sectors are imposed in a non-discriminatory manner on domestic and foreign companies, they can be found to be inconsistent with the TRIMs Agreement since the measures in question involve discriminatory treatment of imported products in favour of domestic products. Non-discriminatory treatment between domestic and foreign investors in the imposition of the LCRs is irrelevant under the TRIMs Agreement.[31]

B. GATT Article III: national treatment principle

GATT Article III prohibits discrimination against imported products, prescribing the national treatment principle, one of the central non-discrimination principles of the WTO system. In principle, imported products should not be treated less favourably than like domestic products once the imported products have entered the domestic market (i.e. once customs have cleared them). Due to their very nature of conditioning an advantage

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[30] Panel Report (2012) *Canada – Renewable Energy*, para 7.108; Panel Report (2016) *India – Solar Cells,* paras 7.62-3; Panel Report (1999) *Indonesia – Auto*, paras 14.80 and 14.82.
[31] WTO, 'Agreement on Trade Related Investment Measures'.

on the use of local products, local content measures are often inconsistent with Article III as they constitute origin-based discrimination (Hestermeyer and Nielsen, 2014).

Indonesia's local content measures discussed in section 2 concern 'laws, regulations, and requirements' (internal regulations) relevant to Article III: 4 rather than a tax advantage (internal tax) where Article III: 2 applies. For reasons of space, Article III: 2 is not included in the discussion of this section.

GATT Article III: 4 provides a basic principle that internal regulations should not be applied to afford protection. Meanwhile, Article III: 5 specifically prohibits WTO members from maintaining quantitative regulations (i.e. requirements to source domestically a portion of the product that will be used in mixture with other components, in processing, or by itself), as they hamper the competitive process in the market. An LCR, which requires a specified percentage of components to be sourced domestically, could be considered a quantitative restriction, which is relevant to Article III: 5.

However, in practice, paragraph 5 is rarely examined by the WTO panel due to the practice of judicial economy, where a panel does not require examining all legal claims made by a complainant party. Therefore, for efficiency reasons, the discussion of Article III: 5 is not included in this section.

1. *Violation of national treatment principle under paragraph 4 of Article III*

For a measure to be found consistent with Article III: 4, the following elements must be demonstrated: (i) the measure at issue must be an internal regulation; (ii) the imported and domestic products are like products; and (iii) the like imported products are not accorded 'less favourable' treatment than like domestic products (Appellate Body Report, 2000, para 133).

The first element concerns whether Indonesia's local content measures are derived from 'laws, regulations, and requirements' that affect 'internal sale, offering for sale, purchase, transportation, distribution or use'. The second element looks at whether favoured local goods and disfavoured imported goods are 'alike'. Finally, the third element asks for the assessment on whether the local content measures modify the 'equality of competitive opportunities' between or among like products as a benchmark establishing 'no less favourable treatment'. Thus, if a complainant party can demonstrate that the advantage conditioned on the use of local goods provided by Indonesia's local content measures negatively affects and modifies competitive opportunities of like imported goods, the 'local content' measures in question would be found violating GATT Article III: 4.

Even if Indonesia's local content measures are in the form of 'conditions' and are 'voluntary' in nature, the measures still fall within the scope of Article III: 4. It has been established in the case law that Article III: 4 also applies to 'measures in the form of conditions that must be satisfied to obtain an "advantage" from the government'.[32] Moreover, as noted by the Panel in *Turkey – Rice*, the measure in question (domestic purchase requirement) is considered a 'requirement' under GATT Article III: 4 'as it is a condition that importers may voluntarily accept in order to obtain an "advantage" from the government' (Panel Report, 2007, para 7.241). Lastly, as pointed out by the panel in *US – Renewable Energy*, evidence showing that the measure may have had 'minimal or no market effects in recent years' is insufficient to rebut a prima facie case that imported products are treated less favourably than like domestic products (Panel Report, 2019, para 7.307).[33]

2. Derogation under paragraph 8(a) of Article III – government procurement

Although most local content measures can be challenged under Article III: 4, the wording of Article III: 8(a) suggests that government procurement is not subject to the obligations under Article III. Further, the panel and the Appellate Body (AB) in the *Canada – Renewable Energy* dispute found that Article III: 8(a) derogation is also 'applicable to measures that fall within the scope of Article 2.2 of the TRIMs Agreement and the Illustrative List annexed thereto' (Panel Report, 2019, para 5.33).

Thus, Indonesia's preference towards domestic products in government procurement projects in the energy and pharmaceutical sectors would arguably be excluded from the scope of national treatment under Article III (also TRIMs Agreement) by virtue of the operation of Article III: 8(a), provided that these LCR measures in government procurement meet the requirements set out in paragraph 8(a) of Article III.

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[32] Article 21.5 Panel Report (2001), *US – FSC*, para 8.139.

[33] See also WTO, WTO Analytical Index: GATT 1994 – Article III (Jurisprudence)'.

For a measure to fall within the scope of Article III: 8(a), first, there must be a connection between the challenged measure (i.e. the law, regulation, or requirement) and the procurement; second, the measure involves ‘procurement by a governmental agency’; and third, the ‘products purchased’ must be procured for ‘governmental purposes’, and ‘may not be with a view to commercial resale or with a view to use in the production of goods for commercial sale’ (Panel Report, 2019, para 5.39).

The first prong is significant and relevant to Indonesia’s LCRs in the energy sector (electricity infrastructure and upstream oil and gas). In the *Canada – Renewable Energy* dispute, Canada tried to justify their Feed-in-Tariff (FIT) Program, which conditioned a minimum level of component parts and services sourced from the producers within the Ontario region in the construction and development of the facility (generators utilising solar PV or wind power technologies) producing the electricity to benefit from the program as government procurement. FIT is a long-term contract by a government agency to secure a wholesale of electricity at a rate attractive to investors and developers (Charnovitz and Fischer, 2014).[34] The panel found that the government of Ontario procured the electricity from the equipment subject to the domestic content requirements. Therefore, there was a ‘close relationship’ between the products affected by the domestic content requirement (renewable energy generation equipment) and the product procured (electricity). As a result, the panel held that the domestic content requirements are those governing the procurement of electricity by the government of Ontario under the FIT program (Panel Report, 2012).

However, the AB disagreed with the panel’s finding and accepted the EU’s argument that the domestic content requirement of the measure at issue is renewable energy generation equipment which is ‘completely disconnected’ from the product purchased by the government which is electricity (Appellate Body Report, 2013, para 5.80). According to the AB, the conditions for derogation under Article III: 8(a) must be read in the context of the other paragraphs of Article III. This means that the discriminated product of foreign origin must be competitive with the product procured. In this case, the product procured is electricity, whereas the product discriminated against is generation equipment, both of which are not in the competitive relationship.[35]

[34] Also, Government of Ontario, ‘Feed-In-Tariff Program’.
[35] Ibid., para 5.79.

Consequently, if a complainant against Indonesia's LCRs in the energy sector can demonstrate that the product subject to the LCRs is generation equipment (e.g. power plant, pumping unit, or machinery) while the product procured is electricity or oil and gas, and the 'product purchased' and the 'product of foreign origin discriminated against' do not compete, Indonesia would find it hard to rely on the derogation of Article III: 8(a).

Concerning the second prong, the AB in *Canada – Renewable Energy* considered the term 'governmental agency' to refer to 'those entities acting for or on behalf of the government in the public realm within the competences that have been conferred on them to discharge governmental functions.'[36] Thus, generally speaking, the SOEs (e.g. PLN or Pertamina) selected or mandated to implement specific government or public projects will be considered a government agency. Therefore, the procurement conducted by such a government agency will fall within the context of Article III: 8(a). However, the purchase of local components by a power plant developer or contractor (private entity) to enjoy the benefits in the procurement process offered by a government agency (i.e. PLN or *SKK Migas*) will not satisfy the second prong of Article III: 8(a), which will therefore not apply (Hestermeyer and Nielsen, 2014).

Turning to the third prong, the panel in *Canada – Renewable Energy* found that the resale of electricity purchased through the FIT program is 'commercial'. The government of Ontario and the municipal government profit from the resale of electricity (Panel Report, 2012).[37] Thus, Canada's defence under Article III: 8(a) was found to have failed to meet the third prong ('not be with a view to commercial resale'). The panel did not rule on the existence of 'government purposes' because they viewed that where a government purchase of goods is made 'with a view to commercial resale', it cannot be considered a purchase 'for governmental purposes'.[38] The AB disagreed with this panel's preposition and argued that the terms 'for governmental purposes' and 'not with a view to commercial resale or with a view to use in the production of goods for commercial sale' are two cumulative requirements to be satisfied under Article III: 8(a). The AB also clarified the term 'products purchased for governmental purposes', as follows:

[36] Ibid., para 5.61.
[37] Para 7.151. According to the panel, loss-making sales can be, and often be, a part of ordinary commercial activity.
[38] Ibid., para 7.145.

> … the phrase ‘products purchased for governmental purposes’ in Article III: 8(a) refers to **what is consumed by government or what is provided by government to recipients in the discharge of its public functions.** The scope of these functions is to be determined on a case-by-case basis. Finally, we recall that Article III: 8(a) refers to purchases ‘for governmental purposes’. The word ‘for’ relates the term ‘products purchased’ to ‘governmental purposes’, and thus indicates that **the products purchased must be intended to be directed at the government or be used *for governmental purposes***. Thus, Article III: 8(a) requires that there be a rational relationship between the product and the governmental function being discharged *(emphasis added)* (Appellate Body Report, 2013, para 5.68).

In the end, while the panel found Canada’s Article III: 8(a) defence failed on the third prong, the AB ruled such panel’s findings as ‘moot’ and of no legal effect (Appellate Body Report, 2013). Nevertheless, the AB found that Canada’s FIT program did not meet the first prong of Article III: 8(a). In other words, both the panel and the AB agreed that Canada’s government procurement under the FIT program failed to fall within the scope of Article III: 8(a), albeit for a different reason. The narrow assessment of the panel and the AB in *Canada – Renewable Energy* suggests that LCR measures packaged as government procurement do not automatically or necessarily fall within Article III: 8(a) derogation.

C. Prohibited subsidies under the SCM Agreement

LCR measures related to government procurement that are neither subject to Article III due to paragraph 8(a) nor the GPA may be contested under the Agreement on Subsidies and Countervailing Measures (SCM Agreement).

The measure, to be challenged under the SCM Agreement, must constitute a subsidy. Article 1.1 of the SCM Agreement defines ‘subsidy’ as containing three main elements: (i) a financial contribution, (ii) by a government or any public body within the territory of a WTO member, (iii) which confers a benefit to its recipient. Moreover, only ‘specific’ subsidies are subject to the SCM Agreement disciplines. The specificity within the meaning of the SCM Agreement includes (i) enterprise specificity; (ii) industry specificity; (iii) regional specificity; and (iv) prohibited subsidy, i.e. a government's subsidy targeting export goods or goods using domestic inputs.[39]

Indonesia's LCRs in government procurement to support the local API industry, enabling them to manufacture exported pharmaceutical raw materials eventually, could be potentially problematic under the SCM Agreement. Similarly, the LCR measures to reduce the import dependence of pharmaceutical raw materials and promote the domestic upstream pharmaceutical industry can be characterised as an import-substitution subsidy.

According to Article 3 of the SCM Agreement, there are two types of prohibited subsidies: export subsidies and import substitution subsidies. Article 3.1(a) prohibits subsidies contingent upon export performance, such as direct export subsidies and export retention schemes, which involve a bonus on exports.[40] Put differently, subsidies requiring recipients to meet certain export targets or to use domestic goods are prohibited, as they are likely to negatively affect other countries' trade. As an illustration, the WTO AB in *Canada – Autos* concluded that an import duty exemption that is available only to a manufacturer that exports motor vehicles is contrary to Article 3.1(a) of the SCM Agreement, as the exemption is conditional upon the exportation of products (Appellate Body Report, 2004). If to support the production of pharmaceutical products for exports the government of Indonesia issues a price preference, bonus, or any tax incentives that are only available when the producers meet the LCRs, this might conflict with Article 3.1(a) of the SCM Agreement.

Moreover, import substitution subsidies are prohibited under Article 3.1(b) of the SCM Agreement, which defines import substitution subsidies as those contingent upon domestic use over imported products. Often, such schemes take the form of local content requirements. The AB in *US – Tax Incentives* noted that the term 'over' in Article 3.1(b) refers to 'the use of domestic goods in preference to, or instead of, imported goods' (Appellate Body Report, 2017, para 5.11). The AB also pointed out that the term 'goods' may refer to any type of goods used by the subsidy recipient, such as, among other things, parts or components incorporated into another good (Appellate Body Report, 2017). As the provision of a price preference for government procurement of pharmaceutical products is contingent upon the fulfilment of certain local content value, including the

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[39] WTO, 'SCM Agreement'.
[40] The Illustrative List of export subsidies is provided in Annex I of the SCM Agreement.

use of domestic APIs, potential legal issues with Article 3.1(b) of the SCM Agreement could arise.

3. Looking Ahead – Recommendation and Conclusion

Today, LCRs have increased and are becoming a popular policy instrument to support domestic industries. Indonesia appears to have increasing recourse to such policy measures, particularly in the strategic sectors of pharmaceuticals, energy, telecommunications, and modern retail, among other things. The broader objective of upgrading the country's competitiveness and rebalancing the trade deficit is a driver of the current administration in unfolding local value addition in stated sectors, which were deemed protectionist and trade-restrictive by certain WTO members.

The use of LCRs, including in government procurement, is disciplined by the multilateral trade system, as seen in the WTO rulebook and case law. WTO agreements regulating trade in goods, namely, GATT, the TRIMs Agreement, and the SCM Agreement, and the 'plurilateral' GPA to which Indonesia is a non-signatory member, in principle prohibit trade-distorting LCRs.

The legal analysis conducted earlier shows that Indonesia's LCRs in energy, telecommunication devices, pharmaceutical, and modern retail sectors are dubious and potentially violate WTO law. An advantage conditioned on the use of domestic goods, which negatively affects and modifies competitive opportunities of like imported goods, is inconsistent with the TRIMs and GATT, particularly the national treatment principle, even if the measures are couched in a voluntary manner.

While LCR measures qualified as government procurement are excluded from national treatment obligation, under GATT Article III: 8(a), the assessment by the panel and the AB in *Canada – Renewable Energy* narrowed the scope of what can be considered 'government procurement' to be eligible for Article III: 8(a) derogation. Therefore, unless certain elements or criteria (explained previously) are demonstrated, it would be hard for Indonesia to shield the LCRs required in government procurement from national treatment obligation by invoking Article III: 8(a) derogation.

Even if LCR measures governing government procurement are qualifying Article III: 8(a) derogation, the measures can be a case under the SCM Agreement when the government offers price preference, bonus, or any tax incentives to the beneficiaries that meet the LCRs in the production of export-oriented products.

Interestingly, cases relating to the LCRs brought to WTO dispute settlement are considerably low, despite the LCRs' popularity as a policy tool and potential illegality under WTO law. For example, some of Indonesia's LCRs have been labelled long-standing issues in the WTO TRIMs Committee meeting; none of them have been challenged in WTO dispute settlement to date. This basic fact does not remove their possibility to be a case in the future, including in a 'tit-for-tat' dispute. To illustrate, soon after the WTO panel found India's local content on solar cells challenged by the US to be WTO inconsistent, India brought a claim against US measures relating to domestic content requirements and subsidies on renewable energy. Being involved in two international disputes simultaneously would be very costly for Indonesia.

Thus, the recommendation is that the Indonesian government prudently design and implement LCRs, considering the WTO strict regime on LCRs. Although facing the actual dispute might not be imminent at present, Indonesia must carefully assess the legality of LCR adoption and implementation vis-à-vis its rights and obligations under WTO law. Equally important, Indonesia must also study the economic impact of LCRs, and explore alternative policy schemes. Industrial policy should not rely solely or largely on LCRs.

Annex I: WTO Disputes on LCRs (Panel and/or Appellate Body Report Circulated and Adopted)[1]

DS No.	Title of the Dispute	Status (as of July 2021)	Agreements Cited in Panel Request
DS510 (India)	US – Certain Measures Relating to Renewable Energy	Panel Report under appeal on 15 August 2019	GATT: Art III: 4. SCM: Arts 1.1, 3.1(b), 3.2, 25. TRIMs: Arts 2.1, 2.2.
DS497 (Japan) DS472 (EU)	Brazil – Certain Measures Concerning Taxation and Charges	Panel and AB Reports adopted, with recommendation to bring measure(s) into conformity on 11 January 2019	GATT: Arts I: 1, III: 2, III: 4, III: 5. TRIMs: 2.1, 2.2. SCM: 3.1(b), 3.2, 1.1.
DS456 (US)	India – Solar Cells	Compliance proceeding ongoing on 28 February 2018 Authorisation to retaliate requested on 12 January 2018	GATT: Art III. TRIMs: 2.1.
DS438 (EU) DS444 (US) DS445 (Japan)	Argentina – Measures Affecting the Importation of Goods	Panel and AB Reports adopted, with a recommendation to bring measure(s) into conformity on 26 January 2015	GATT: Arts III: 4, X: 1, X: 3, XI: 1 (DS438/444/445). Import Licensing: Arts 1.3, 1.4, 1.6, 3.2, 3.3, 3.5(f) (DS438/444), Art 5.1, 5.2, 5.3, 5.4 (DS444/445).
DS426 (EU) DS412 (Japan)	Canada – Measures Relating to the Feed-in Tariff/ Canada – Measures Affecting Renewable Energy Generation Sector	Implementation notified by the respondent on 5 June 2014	GATT: Art III: 4 (DS426/412), Art XXIII: 1 (DS412). SCM: Art. 3.1(b), 3.2, 1.1 (DS426/412). TRIMs Art 2.1 (DS426/412).
DS342 (Canada) DS340 (US) DS339 (EC)	China – Measures Affecting Imports of Automobile Parts	Implementation notified by the respondent on 31 August 2009	GATT: Arts III: 2, III: 4, III: 5, III: 1, II: 1, X: 1. (DS342/340/339), Art X: 3 (DS342), Art XIII: 1 (DS339). TRIMs: Art 2.1 (DS342/340/339), Art 2.2 (DS339). SCM: Art 3.1(b), 3.2 (DS342/340), Art 3 (DS339). Protocol of Accession (DS342/340/339)
DS334 (US)	Turkey – Measures Affecting the Importation of Rice	Implementation notified by the respondent on 21 October 2008	Agriculture: Art 4.2. GATT: Arts XI: 1, X: 2, III: 4, X: 3(a). Import Licensing: Arts 1.4, 3.3, 3.5 (e)-(h), (a)-(b), 1.2, 1.3, 1.5, 1.6, 3.2, 5.1, 5.2, 5.3, 5.4. TRIMs: Art 2.1, Annex 1.

[1] See WTO, 'Disputes by Agreement – Trade-Related Investment Measures (TRIMs)', https://www.wto.org/english/tratop_e/dispu_e/dispu_agreements_index_e.htm (accessed 28 July 2021).

DS276 (US)	Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain	Implementation notified by the respondent on 31 August 2015	GATT: Arts III: 4, XVII: 1. TRIMs: Art 2.
DS175 (US) DS146 (EC)	India – Measures Affecting Trade and Investment in the Motor Vehicle Sector/ India – Measures Affecting the Automotive Sector	Implementation notified by the respondent on 11 November 2002	GATT: Arts III:4, XI:1. TRIMs: Arts 2.1, 2.2.
DS142 (EC) DS139 (Japan)	Canada – Certain Measures Affecting the Automotive Industry	Implementation notified by the respondent on 12 March 2001	GATT: Arts I: 1, III: 4 (DS142/139), Art XXIV (DS139). SCM: Art 3.1(a) (DS142/139), Art 3.1(b), and 3.2 (DS142). GATS: Arts II, VI, XVII (DS142/139). TRIMs: Art 2 (DS139), Art 2.1 (DS142).
DS54 (EC) DS55 (Japan) DS59 (US) DS64 (Japan)	Indonesia – Autos	Implementation notified by the respondent on 26 July 1999	TRIMs: Art 2 (DS54/55/59/64). GATT: Arts I: 1, III: 2 (DS54/55/59/64), Art III: 4 (DS55/59/64), Arts X: 1 and X: 3(a) (DS55/64), Art III:7 (DS59). SCM: Arts 1, 2, 6 (DS54/59), Art 28.2 (DS55/59/64), Arts 3 and 5 (DS64). TRIPs: Arts 3, 20, 65 (DS59)

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