Host Country Policies: Performance Requirements

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A host nation "performance requirement" is defined as any requirement placed by that nation upon a foreign controlled firm designed to further national policies or goals. The discussion in this paper is limited to those performance requirements which have a traceable effect upon world trade. Perhaps the most obvious generic example is one that the firm export some minimum portion of its output. Such a requirement may take several forms. For example, the firm may be required to export a minimum percentage of its shipments; or, the firm might be required to earn via exports enough foreign exchange to cover costs of imported inputs; or, the firm might be required to meet some absolute export target.

A second generic example of a trade-related performance requirement is import substitution. Again, import substitution requirements can take several forms, including ones in which the requirement is implicit: a) mandatory local assembly or final stage of manufacture of end-products previously imported; b) local content requirements, mandating local manufacture or purchase of intermediate products or
inputs which the firm might otherwise choose to import (an extension of this type of requirement would be mandatory local performance of research and developments); c) local value-added requirements, specifying a minimum percentage of value-added which must be local; and d) requirements that a firm create a minimum number of local jobs.

These examples of export and import substitution requirements are not exhaustive, and other variations can be cited. Additionally, other regulations or requirements placed by host governments upon foreign controlled firms may have indirect trade effects. For example, requirements for technology transfer or training of local workers might have these effects.

Performance requirements are often linked to other host nation policies or practices. For example, performance requirements can be attached as a condition of entry into a nation, so that an international investor must agree to abide by the requirements in order to receive host government authorization to conduct business in the nation. Also, performance requirements can be attached to investment incentives or other favorable treatment accorded by the host government.
Results of a 1978 U.S. Department of Commerce survey of investment incentives and performance requirements in 40 nations indicate that virtually all of these impose some form of performance requirements on at least some local affiliates of foreign corporations. Another Department of Commerce study shows that about 10% of overseas affiliates of U.S. corporations are subject to some sort of performance requirement. The most common requirements are for minimum local labor content and minimum local equity participation. This second study indicates that about 14% of affiliates operating in developing nations are subject to minimum local labor content or employment requirements, while only 2% of affiliates operating in developed nations are subject to similar requirements. About 12% of affiliates operating in developing nations are subject to minimum local equity participation requirements, against about 2% in developed nations. A small but significant number of subsidiaries are subject to minimum export or maximum import requirements. In developing nations, about 3% of the affiliates reported export requirements and about 4% import requirements. Under 1% of affiliates operating in developed nations reported either export or import requirements. The overall incidence of performance requirements would appear to be higher for subsidiaries operating in developing nations than in developed nations, and higher for Latin American nations.
than for non-Latin developing nations. Because of a possible misinterpretation of the survey questionnaire used in this study, it is possible that these figures understate the true incidence of performance requirements.

Performance requirements, while most often applied to foreign-owned firms by host nations, are not infrequently applied to purely domestic firms as well. Most of the arguments developed in this paper apply equally to performance requirements placed on local firms and to those placed on foreign firms.

The position to be developed in this paper is that indiscriminate application of performance requirements by host governments may have undesirable economic effects, including both reduction of global allocative efficiency and (in some cases) reduction of welfare to the host nation itself. Additionally, it will be demonstrated that performance requirements raise serious issues of international comity.

Performance Requirements, Global Economic Efficiency, and Host Nation Welfare

According to a standard theorem of neoclassical economics, global economic efficiency - and hence gross wealth - are maximized if international trade is allowed to proceed unfettered by governmental interference. Governmental interference in this context can imply border taxes or other
restrictions on imports and restrictions on or inducements to exports. Numerous conditions are attached to the theorem, however, and it is worthwhile reviewing these.

The conditions attach to both the supply and demand side of the market and to the functioning of the market itself. With respect to the functioning of the market itself, the theorem holds only if there are no non-governmental barriers to trade which would cause price differentials for the same commodity to exist in different markets. Thus, there must exist, net of transport and transaction costs and taxes, one world price for each traded commodity. On the supply side, markets for factors of production must be competitive, as must be the structure of the producing industry. Additionally, all actual and potential producers worldwide must be able to employ identical technologies for the design and manufacture of traded goods.

On the demand side, the conditions necessary for the theorem to hold are complex and are not relevant to the arguments to be developed in this paper. Hence, they are not repeated here.*

* For the sake of completeness, the principal conditions are that there must exist for each trading nation a community utility function, although it need not necessarily be the same function for each nation. Sufficient (but not necessary) conditions for the existence of such a function are that two out of three of the following hold: 1) all incomes of consumers within the nation be identical; 2) all consumers hold identical tastes; and 3) preferences of individual consumers be homothetic.
If all of these conditions were to hold, and trade were to be free of governmental interference, nations would specialize in the production of those goods in which they possessed a comparative advantage, determined by factor endowment. It follows that global economic efficiency would, in a static world, be maximized. Under these conditions, there would be no economic justification whatever for performance requirements.

Host nations which impose performance requirements, however, justify these on the grounds that not all of the conditions for static efficiency hold. Some of the most common cited justifications are as follows:

1) **Noncompetitive producing industries:** international investment has been shown to occur largely in industries marked by a significant degree of producer oligopoly. Oligopolistic power as exercised by multinational firms, it is claimed, works to the disadvantage of host nations. Overt manifestations of this include practices which would not be sustainable in a competitive industry such as (a) transfer pricing at nonarm's-length prices between parent firm and subsidiary so as to reduce the latter's reported profits for host nation taxation purposes; (b) "tie-in" and other restrictive clauses imposed upon local subsidiaries as a
precondition for technology transfer, and (c) export restrictions being placed on local subsidiaries by parent firms.

While it is doubtlessly true that such practices do occur, it is difficult to justify performance requirements as a "best practice" solution to them. Transfer price abuses can be dealt with directly by enforcing that firms use established international prices in reporting intra-firm transactions, and, when such prices do not exist, requiring that the firm justify that the transfer price used is a reasonable approximation of an "arm's length" price.

In the long run, noncompetitive behavior among multinational firms can be combatted by reduction of national barriers to entry to any given industry or sector. To some large degree this implies adoption and enforcement of strong
anti-trust measures. Nations which are predominantly host to foreign investment, by imposing entry conditions and other policies which discriminate against international investors, tend to create barriers to entry which serve to reinforce oligopolistic behavior of firms already participating in the local market. Nations which thus grant monopolistic or quasi-monopolistic status to one or a few firms and deny access to their domestic markets to other potential investors, foreign or domestic, tend to encourage undesirable behavior on the part of the favored firms. Therefore, for example, nations which impose performance requirements as a condition of entry to a foreign investor may be acting to reduce the long run efficiency of their domestic industries and, indeed, to increase the oligopolistic powers of multinational firms.

2) Non-identical technologies: a vast literature has been developed which indicates that comparative advantage among nations is at least as determined by differing levels of technological attainment as by differences in factor endowments. Technology - the knowledge requisite to the production of useful goods and services - can, however, be transferred from one nation or region to another. Such transfer causes shifts of comparative advantage among nations.
Additionally, new technologies are constantly being created as entrepreneurs create new products and develop more efficient techniques for making older ones, and introduction into the market of new technologies can also alter comparative advantage.

A developing nation might possess a "latent" comparative advantage (i.e., one based on factor endowment) in some sector but might lack the technology requisite to capitalizing upon this latent advantage. By acquiring or developing the technology, the nation can shift comparative advantage in its favor, a move that would increase its own welfare. Additionally, under the premises of the neoclassical theorem presented above, the shift would enhance world welfare as well.

It is possible that performance requirements can, in principle, be used to create or accelerate such a shift. If a nation is able correctly to identify those sectors in which it holds "latent" comparative advantage, it might be able by judicious use of various performance requirements to induce foreign firms which hold necessary technologies to transfer these to the local economy. By requiring potential investors to export, the nation would tend to encourage investment in those sectors in which the nation potentially could become internationally competitive. Local content requirements might facilitate the development of
networks of supplier firms necessary for the emergence of a fully competitive sector. Technology transfer requirements might help to ensure that necessary knowledge is brought into the economy and that local personnel are taught the skills necessary to utilize this technology.

Several dangers, however, underlie this reasoning. The major danger lies in the possibility that performance requirements are imposed in the wrong sectors, ones in which no "latent" comparative advantage exists. If performance requirements are imposed upon firms operating in sectors in which the nation has no reasonable hope of becoming competitive internationally, and, consequently, these noncompetitive sectors expand, the result would be a misuse of the nation's resources. In order to remain in business and maintain employment, noncompetitive producers would have to be subsidized, either explicitly via an operating allowance from the government or implicitly via import restrictions. The result would be loss of potential welfare to the nation, manifesting itself in one or several forms: higher prices for consumers, persistent inflation, higher than necessary taxes, or retarded growth. Additionally, the economy may be saddled with obsolete or outdated end products produced by the inefficient sector.
The ill effects would not be confined to the host nation. By depriving other nations of the opportunity to expand their own efficient industries and export to the host nation, the misbegotten performance requirements would adversely affect these other nations' welfare. Global economic efficiency would be reduced.

From the host nation point of view, the problem is to place performance requirements only upon firms operating in sectors in which the nation can become competitive. If the sectors to which performance requirements are applied are properly chosen, then, arguably, these requirements could hasten shift of comparative advantage and result in more rapid development of the economy than would otherwise occur. If, however, the sectors are poorly chosen the performance requirements would be counterproductive.

These arguments for and against performance requirements are exactly the same as those for and against the "infant industry" case. It is argued by some development economists that developing nations must accord a high degree of protection to local industries in order to allow them to grow from an embryonic, internationally noncompetitive stage to one in which they can compete in world markets. The counterargument is that if the sectors accorded protection are poorly chosen, the transition from a noncompetitive to a competitive status
will never come. Additionally, even in sectors in which the nation possesses a latent comparative advantage, protective measures may actually retard or even prevent such a transition. This is because the local industry will be sheltered from the stimulatory discipline of having to compete with efficient firms.

The case can be made that, given the difficulty of determining sectors in which a nation has the potential of becoming competitive, it would be better for market forces to determine allocation of resources than for this to be attempted through a centralized, bureaucratic process. Host governments can facilitate selection by the market of sectors which can become competitive by maintaining open entry conditions as already outlined: by not pursuing policies which act as a deterrent to investment and by not granting to any firm - whether it be a locally controlled one or a subsidiary of a foreign firm - a monopolistic or otherwise privileged position in the local market.

This does not imply, however, that the role of the host government necessarily should be a neutral or passive one. The government can facilitate shifts in comparative advantage by means of building up physical and social infrastructure. In particular, it can provide to its citizens educational
services. The availability of workers who possess mechanical and technical skills is a prerequisite for the transfer of most industrial technologies, and the teaching of these skills in the nations or regions can be provided only by government. The same is true for transportation and telecommunication services, which in many regions can be provided more efficiently by the government than by private providers. In some instances the government must act as provider of health care and housing services as well. Adequate provision of such services is not irrelevant to the international investment process, nor indeed to any aspect of the process of industrialization.

Performance Requirements and International Comity

Two premises can be identified which underlie much of the principle of comity in world trade law. The first is that nations generally should not engage in policies or practices which serve to restrict or limit unduly international trade. The second is that nations should not engage in trade practices which are overly disruptive to the domestic industries of other nations. It is clear that these two premises are to some extent in conflict with one another, given that trade expansion necessarily must disrupt existing patterns of industrial production.
A doctrine of comity therefore must chart something of a middle course between these premises. Performance requirements can violate both premises.

Import substitution requirements frequently involve restrictions or limitations on imports into a nation. Even if overt restrictions do not exist, tacit or implicit restrictions are nearly always present. These requirements can also be disruptive to other nations' industries, most notably in the case of those nations which exported to the restricted market prior to the imposition of the requirements or which would commence to do so following a new investment.

Most import restrictions are, of course, in violation of the GATT. Prohibitive tariffs are in violation of signator nations' obligations with regard to tariffs as formulated under Article II of the GATT and the "bindings" that are an integral part of the article. Most import quotas are prohibited under Article XI. Other non-tariff barriers to trade are limited under Articles VII, VIII, IX, and X.

To be sure, there exist exceptions to these GATT restrictions which apply to developing nations. Article XVIII of the GATT allows developing nations to raise tariffs above levels prescribed in the bindings for a variety of
reasons, including "infant industry" reasons. The same article also allows the use of quantitative restrictions on imports for balance-of-payments reasons, granting to developing nations more lenient criteria than those generally granted under Article XII. Part IV of the GATT, comprising Articles XXXVI through XXXVIII, grant additional powers to developing nations to implement selective trade restrictions.

Even without the exceptions, the GATT regulations designed to reduce or eliminate trade barriers would be difficult or impossible to apply to cases of import substitution requirements imposed singularly upon individual firms by a host nation. For example, if a foreign controlled firm is ordered by its host government to increase local value added, the government is de facto placing a restriction on imports even if de jure this restriction could not be demonstrated. Remedial measures could be difficult to apply by other nations.*

Export performance requirements are also thorny. Such requirements may be disruptive to other nations, especially if the requirements were imposed without regard to supply and demand conditions in world markets.** Extreme

* But see discussion in the following section.

disruption resulting from export performance requirements presumably would be met by remedial action by the affected nations through escape clause action, or if the case warranted, remedies prescribed under the subsidies/countervailing measures code, or other measures. Such action, however, would most likely be undertaken only after the disruption reached high levels, and could not be applied by aggrieved nations in third market situations.

Nations which impose export performance requirements are thus most likely to be able to do so with impunity so long as the consequences are not extremely disruptive or import restrictions are implicit rather than overt. Extreme disruption would not likely occur even if several nations were to impose similar requirements as long as the total of such nations was not large. It is thus possible to conceive that a small number of nations could enjoy something tantamount to a "free rider" status by imposing such requirements. If, however, increasing numbers of nations were to impose export performance requirements in any given sector, disruption would mount. Efforts by each exporting nation to increase its exports would place considerable stress on the world trading system and would almost certainly lead to countervailing efforts by importing nations.
One fundamental issue raised by performance requirements thus is that of international comity. One nation's requirements, carried out in isolation, might tilt slightly the benefits of international investment and trade in its direction, at the expense of other nations. Although it would in some sense be unfair for the one nation to do so, its actions alone would generally not be sufficiently harmful as to pose problems to the world order. However, as more nations attempted to pursue similar policies, the level of disruption would rise until it became great enough to cause severe stress on the entire system. Historical evidence suggests that when one nation actively pursues a policy designed to tilt benefits in its direction, emulation of that policy by other nations can rapidly follow. The results can be disastrous. For example, worldwide emulation of tariff escalation by the United States under the infamous Smoot-Hawley Act of 1930 doubtlessly deepened and prolonged the Great Depression. The United States suffered greatly during the Depression, and it is now generally acknowledged that whatever short-run benefits the nation might have obtained from the Smoot-Hawley Act were swamped by ill effects spawned by the Act. While no suggestion is being made here that the present situation
is quite so serious, the example does demonstrate that the case against a nation's unilaterally pursuing policies to tilt benefits in its direction is not simply a theoretical one. The cumulative effect of many nations' performance requirements is bound to have a depressing effect on the world economy at some point.

International Policy Considerations

The previous section suggests that practices associated with performance requirements may be inconsistent with the spirit of the GATT and that the effects of these practices may negate some of the benefits of freer world trade. At the same time, however, it is noted that these practices may not be in direct violation of any specific GATT provision, or that violation may be difficult to demonstrate even when it occurs.

Nonetheless, the GATT mechanism provides some opportunity for drawing attention to practices which are unsettling to international comity. The GATT notification and consultation procedures and the dispute settlement mechanism are ones which could be used on a test case basis to establish precedents with regard to what specific practices are inconsistent with GATT obligations. Some danger lurks in the use of these mechanisms. The disputes settlement
mechanism in recent years has tended to function clumsily, with the result that specific disputes have dragged on interminably without effective settlement. Non-resolution of disputes can be tantamount to an implicit GATT condoning of acts or practices which are clearly inconsistent with the language or spirit of the GATT itself. Nonetheless, the GATT mechanisms can and should be used as one means to settle international disputes, and it would be useful if nations holding specific grievances against other nations relating to performance requirements were to utilize these mechanisms.

Article XIII, Section 2, provides a basis for raising complaints. This section allows a GATT member to bring action against any practice which nullifies or impairs any benefit accruing to the member directly or indirectly. The practice need not necessarily violate a specific provision of the GATT. At a minimum, all that is needed is a demonstration that the practice has the effect of undermining the benefits of tariff concessions on a particular product. Thus, for example, one nation's practices which implicitly create import barriers to a product can be challenged by exporters of the product.*

* In fact, depending upon the specific practices, import restricting performance requirements could be in violation of any of four separate GATT provisions.

Article III, Section 1, which prohibits internal quantitative regulations requiring the use of products in specified amounts "so as to afford protection to domestic production."
While the GATT mechanisms doubtlessly are useful for raising issues and settling disputes with regard to performance requirements, it is possible to conceive of situations where the GATT simply cannot work effectively to curtail practices unsettling to international comity. In the previous section, it was suggested that performance requirements applied individually to single firms would be difficult or impossible to police under GATT rules. It thus might be the case that new rules are needed to deal with the problem.

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Article III, Section 5, which prohibits internal quantitative regulations requiring that specified amounts of any product be supplied from domestic sources.

Article XI, Section 1, which prohibits restrictions other than duties, taxes, or other charges whether made effective through quotas or other measures on the imports of any contracting parties.

Article II, Section 1a, which prohibits import restrictions beyond those specified in the appropriate GATT schedule of the country for products on which the country has a GATT tariff binding.
FOOTNOTES

1. For evidence see S.H. Hymer, *The International Operations of National Firms: A Study of Direct Foreign Investment* 1960; (reprinted by the MIT Press, 1976);
   Raymond Vernon, *Sovereignty at Bay* (Basic Books, 1971);