LOCAL CONTENT AND

RELATED TRADE POLICY:

AUSTRALIAN APPLICATIONS

by Elizabeth S. M. Manning
School of Economics
University of Adelaide

April 2004
ABSTRACT

Local content schemes provide protection for domestic intermediate input-producing industries by encouraging producers of final products (goods and services) to purchase a minimum proportion of their inputs from local producers.

This thesis analyses the effects of this type of scheme on three industries, one each from the agricultural, manufacturing and services sectors: the Tobacco, Automotive and Broadcasting industries in Australia. It finds that local content schemes often result in high levels of assistance to the protected input-producing industry, with consequent wastage of resources and high costs to other areas of the economy. It is a relatively hidden form of protection, and each of the industries studied has developed entrenched and powerful interests that have been able to ensure the continuation of assistance far and above that afforded other industries.

Local content schemes became illegal for goods (but not services) under the World Trade Organization (of which Australia is a member) following the Uruguay round of negotiations (completed in 1994). As a result, local content policy has been phased out in the tobacco and automotive industries, but it continues to be used in the broadcasting industry in Australia.

In addition, local content still plays a significant part in Government purchasing. The insights arising from this thesis can be applied to this area of policy. Government procurement rules (currently subject to a plurilateral but non-compulsory World Trade Organization (WTO) agreement) are under further negotiation in the
current WTO round of multilateral trade negotiations. While Australia is at present not a signatory to the existing plurilateral agreement, joining is an option and so it is appropriate to focus here on the implications of local content provisions in Australia's current state and federal government procurement arrangements.

Finally, this thesis looks at an application of this theory to an area that is becoming increasingly important internationally, namely rules of origin. An increasing proportion of world trade is taking place on a preferential basis, within free trade agreements or customs unions, and also under other preferential trading arrangements. Rules of Origin have become an increasingly complex part of these arrangements, necessary to ensure that products do originate from the country that is allowed preferential access to the other country's markets.

Many of the results applicable to the industry studies in Australia apply to this international setting as well. Rules of origin are often complex, costly to administer (resulting in wastage of resources), distorting to international trade patterns in a way that can impose high costs on third parties, and covertly provide high levels of protection to some industries.

This study attempts to bring to the fore some of the economic costs and political economy considerations associated with the application of local content policies. The key implication is that local content policy is a high-cost way of providing protection to industries in Australia. Given that finding, further careful study of the effects of rules of origin internationally is needed so as to similarly make explicit the costs and distortions associated with their application.
TABLE OF CONTENTS

DECLARATION ................................................................. .............................. 1

ABSTRACT ..................................................................................... iii

TABLE OF CONTENTS ................................................................. iv

LIST OF FIGURES AND TABLES ................................................... viii

LIST OF ABBREVIATIONS ............................................................ ix

LIST OF ABBREVIATIONS ............................................................ ix

ACKNOWLEDGEMENTS ................................................................. xii

CHAPTER 1: INTRODUCTION ...................................................... 1

1.1 The issue ...................................................................... 1

1.2 Organisation of the thesis ........................................................ 7

CHAPTER 2: THE ECONOMICS OF LOCAL CONTENT ............. 11

2.1 Definition of local content .................................................... 11

2.2 Incentives to achieve the local content requirement .................. 14

2.3 The basic model in a static economy ...................................... 17

2.3.1 The market for the intermediate input .................................. 17

2.3.2 Local content scheme versus a tariff ................................... 24

2.3.3 A tariff/production subsidy combination ............................ 28

2.3.4 LCS versus a production subsidy ......................................... 29

2.3.5 Summary ......................................................................... 29

2.4 Comparative statics .............................................................. 31

2.4.1 An increase in the cost of domestic production ................. 33

2.4.2 A decrease in the world price of the input ...................... 34
2.4.3 A change in total demand for the intermediate input ........................................... 36
2.4.4 A decrease in the local content requirement ......................................................... 38
2.4.5 A decrease in the tariff rate on the intermediate input ......................................... 40

2.5 Qualifications to the basic model ............................................................................. 43
   2.5.1 Measurement ....................................................................................................... 43
   2.5.2 Technical efficiency ............................................................................................ 44
   2.5.3 Monopoly in the intermediate goods sector ..................................................... 44
   2.5.4 More than one intermediate input ........................................................................ 46
   2.5.5 Model specification ............................................................................................. 46
   2.5.6 Possible advantages of local content schemes .................................................... 47
   2.5.7 Lack of transparency .......................................................................................... 48

2.6 Discussion and conclusions ....................................................................................... 48

CHAPTER 3: FIRST CASE STUDY: THE TOBACCO INDUSTRY ........................................ 50
   3.1 Introduction ............................................................................................................. 50
   3.2 The industry in overview ....................................................................................... 51
      3.2.1 Under the local content scheme ....................................................................... 51
      3.2.2 The current industry ......................................................................................... 52
   3.3 History of assistance ............................................................................................... 53
   3.4 The impact of protection ......................................................................................... 56
   3.5 Measures of assistance ........................................................................................... 60
   3.6 The local content scheme and the GATT/WTO ..................................................... 61
   3.7 Current assistance arrangements ............................................................................. 63
   3.8 Discussion and conclusions ..................................................................................... 65

CHAPTER 4: SECOND CASE STUDY: THE AUTOMOTIVE INDUSTRY .................... 70
   4.1 Introduction ............................................................................................................. 70
CHAPTER 5: THIRD CASE STUDY: THE TELEVISION INDUSTRY

5.1 Introduction ................................................. 89
5.2 The industry in overview .................................... 92
5.3 History of content regulation ................................ 96
5.4 Current assistance arrangements ............................ 97
5.5 Television and the GATS ................................... 102
5.6 Social objectives ........................................... 103
5.7 Impact of protection ........................................ 107
5.8 Transition to digital television ............................... 110
5.9 Discussion and conclusions ................................ 112

CHAPTER 6: OTHER APPLICATIONS OF THE THEORY: GOVERNMENT PROCUREMENT, OFFSETS AND RULES OF ORIGIN

6.1 Introduction .................................................. 117
6.2 Government procurement .................................... 118
6.3 Offsets ....................................................... 119
6.4 Rules of origin: an international example of a local content scheme ........................................... 121
6.4.1 Introduction ............................................... 123
6.4.2 Defining Rules of Origin ................................................................. 123
6.4.3 ROO and the World Trade Organization ........................................ 124
6.4.4 Krueger’s USA/Mexico example ..................................................... 125
6.4.5 Other applications of Rules of Origin .............................................. 126
6.5 Discussion and conclusions ............................................................... 128

CHAPTER 7: SUMMARY AND POLICY IMPLICATIONS .............................. 129
7.1 Summary of findings ........................................................................... 129
7.2 Implications for policies in Australia and other countries ..................... 133

REFERENCES ............................................................................................ 138