



HERBERT
SMITH
FREEHILLS

Localisation Policy Options in South Africa

Do the DTIC's proposals stack up legally?

04 August 2021

Peter Leon, Partner and Africa Chair (peter.leon@hsf.com)



Domestic regulation of South Africa's local procurement efforts



Domestic regulation of local procurement efforts

Legal framework

- Domestic content requirements in South Africa (**SA**) have traditionally been regulated under the Preferential Procurement Policy Framework Act, 2000 (**Act**) and Preferential Procurement Regulations, 2017 (**Regulations**).
- This legal framework established under the Act and the Regulations allows the Department of Trade, Industry and Competition (**DTIC**) to designate certain sectors for the purposes of imposing local content requirements.
 - The domestic (or local) content requirements mostly apply to *public sector procurement* which does not ordinarily fall within the scope of international trade law as South Africa has not signed or ratified the Agreement on Government Procurement, 2012 (**GPA**).

Domestic regulation of local procurement efforts

Legal framework (cont.)

- After extensive consultation with key sector stakeholders, the SA government devised the Economic Reconstruction and Recovery Plan in October 2020.
 - In President Ramaphosa's 2021 State of the Nation Address, significant emphasis was placed on increasing domestic production in order to revive the manufacturing industry.
 - During the address, President Ramaphosa suggested that this could be achieved by reducing SA's reliance on imports by 20 per cent over the next five years.
- There is a risk that this approach may result in the adoption of protectionist trade policies.
- One recalls Cambridge economist Joan Robinson's observation in the wake of the Great Depression in 1937 that, *“as soon as one country succeeds in increasing its trade balance at the expense of the rest, others retaliate ... Political, strategic and sentimental considerations add fuel to the fire and the flames of economic nationalism blaze higher and higher”*.
- In support of the SA government's approach, the DTIC has increasingly sought to implement domestic content requirements across a number of sectors.
- This is often coupled with external trade policy measures, such as import tariffs, quotas or licensing requirements, which are intended to protect domestic industries from import competition.



**Potential conflict between
proposed localisation plans and
SA's international trade law
obligations**



Potential conflict

General

- Depending on the formulation and implementation of the proposed localisation policies, there is a risk that the measures may contravene SA's international trade law obligations.
- In particular, there is some concern that in order to give effect to the proposed policies, the DTIC may rely upon measures which seek to *shelter* local industries by reducing reliance upon, and *competition* from, *imports*.
- To the extent that the DTIC (or the SA government) creates barriers to cross-border trade in goods and services by employing domestic content requirements or restrictions on imports, this may result in a contravention of the World Trade Organisation's (**WTO**) General Agreement on Tariffs and Trade (**GATT**) or the General Agreement on Trade in Services (**GATS**), to which South Africa has been party since 1 January 1995.

GATT – Article XI

- Article XI of the GATT includes a general prohibition against *quantitative import restrictions* (other than duties, taxes or other charges) which are given effect to by quotas, licences or ***other measures***.
- As Article XI is worded to include "other measures", it has been argued that the prohibition against quantitative restrictions applies to *any measure* instituted or maintained which restricts the exportation or importation of goods, irrespective of the measure's legal status (Panel Report on *Japan – Trade in Semi-Conductors*).

Potential conflict

GATT – Article XI (cont.)

- While not all non-mandatory government policies or requests may be regarded as measures falling under Article XI, there is *sufficient scope* for various levels of government involvement in industries to be subject to the prohibition against quantitative restrictions.

GATT – Article III

- Of particular significance for SA's proposed localisation policies is the *national treatment principle* in Article III of the GATT.
- The WTO Appellate Body in *Japan – Alcoholic Beverages II* described this as providing *equality of competitive conditions* for imported products in relation to domestic products.
 - Article III effectively prescribes that products imported into the territory of another Member State shall be accorded *treatment no less favourable* than that accorded to like products of national origin.
 - This, together with the most-favoured-nation standard, forms the basis of the *non-discrimination principle*, which is a fundamental tenet of WTO law:
 - This includes, for example, *not* imposing internal taxes or charges on imported products which are in *excess* of those applied to similar domestic products.
 - WTO Member States may *not* maintain internal quantitative regulations which prescribe ***specified amounts or proportions*** of products which must be supplied from domestic sources for the purposes of the mixture, processing or use of products.

Potential conflict

GATT – Article III (cont.)

- Article III has been found to apply to various measures which discriminate against imports, *regardless of whether* those imports are ***small or non-existent*** and indeed regardless of whether there is a *negotiated expectation of market access*.
 - Working Party Report on the *Brazilian Internal Taxes*; Panel Report on *India – Solar Cells*.
- There is, in addition, *no intrinsic limit* on the application of Article III to so-called 'pre-market measures' which are directed at producers rather than at a product that is already in the market.
 - Panel Report on *Brazil – Taxation*.
- To the extent that the DTIC's proposed localisation policies result in a change in the *competitive relationship* between imported and domestic products contrary to Article III, this is likely to be regarded as an *impairment of the benefits* accruing to trading partners under the GATT.

Potential conflict

GATT and TRIMs

- There is a substantial overlap between Articles III and XI of the GATT, and Article 2 of the WTO's Agreement on Trade-Related Investment Measures (**TRIMs Agreement**).
- Article 2.1 provides that no Member State shall apply any *trade-related investment measures* which are inconsistent with the provisions of Article III or XI of the GATT.
 - In the case of *India – Solar Cells*, a complaint was initiated in respect of certain domestic content requirements imposed under the Jawaharlal Nehru National Solar Mission for solar cells and solar modules.
 - In order to promote domestic solar energy capacity, the Indian government entered into individual power purchase agreements with solar power developers which mandated the use of ***solar cells and modules manufactured in India***.
 - As the Indian government had prescribed the use of solar cells and modules manufactured in India *only*, imported products could not compete. These domestic content requirements were found to be *trade-related investment measures* which were in contravention of Article III of the GATT.
- In *Brazil – Taxation*, it was found that:
 - Brazil had applied certain taxation and charges on *imports* in the automotive sector which were in excess of those applied to similar domestic products.
 - Domestic content requirements which did not permit certain items within particular production steps to be fulfilled by imports were found to be inconsistent with Article III of the GATT and Article 2.1 of the TRIMs Agreement.

Potential conflict

GATT and TRIMs (cont.)

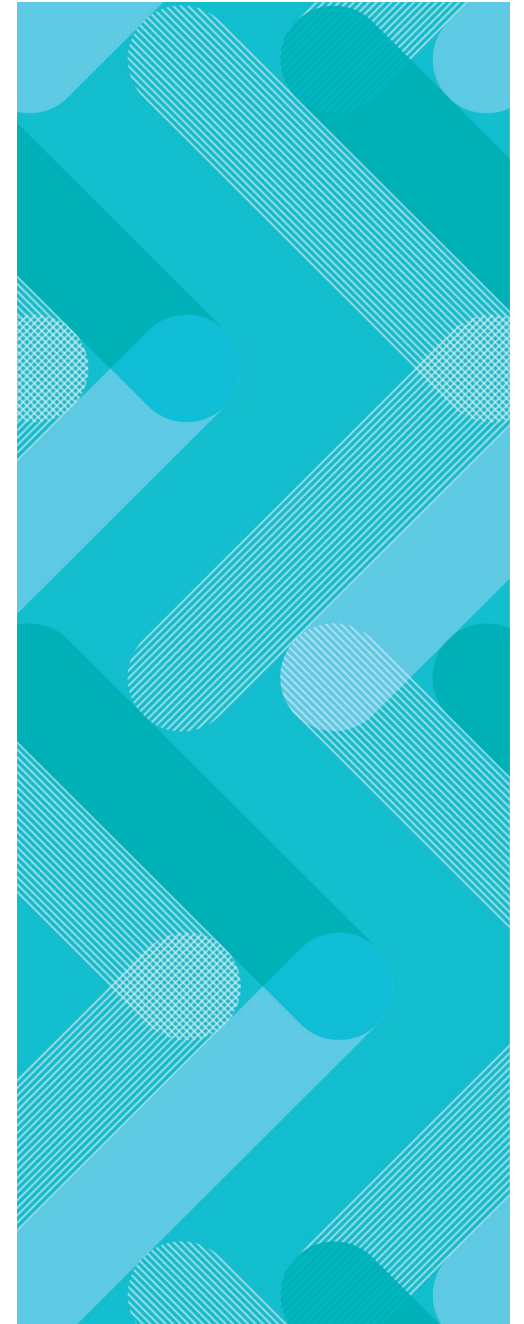
- Article XVII of the GATS similarly obliges Member States to afford *foreign service providers* treatment *no less favourable* than that afforded to domestic service suppliers.
- The emphasis here is placed on ensuring that the conditions of competition are not altered in favour of the Member State's own service industry.
 - In the context of the GATS, each Member State identifies which sectors it will make commitments in respect of, and under what conditions.
 - The extent to which SA is obliged to afford no less favourable treatment to foreign service suppliers will therefore depend on the sectors that SA has included in its *schedule of commitments*, and if they have been made subject any conditions or qualifications.

AfCFTA Agreement

- There are similar non-discrimination obligations in the Agreement establishing the African Continental Free Trade Area (**AfCFTA Agreement**) and the Economic Partnership Agreement between the European Union and the SADC EPA States (**SADC-EU EPA**).
 - Both include provisions mirroring the *national treatment* principle in Article III of the GATT.
 - There is additional scope for SA's trading partners to seek recourse for any measures which alter the competitive conditions between imported and domestic products.



Potential consequences of a breach of international trade law obligations



Potential consequences of a breach

External trade and domestic content policies

- If SA is to adopt external trade and domestic content policies which are non-compliant with the GATT, GATS, TRIMs, AfCFTA or SADC-EU EPA, there is a risk that they may face significant headwinds.
- Insofar as SA is unable to rely upon the exceptions under Article XX of the GATT (none of which appear to be immediately applicable), it may become vulnerable to challenges by other Member States of the WTO who may wish to initiate dispute resolution proceedings by referring a complaint to the Dispute Settlement Body.

DTIC localisation policies

- Should the localisation policies implemented by the DTIC be found to be in contravention of the GATT (with the effect that the benefits accruing to a Member State in terms of the GATT are being nullified or impaired), there is scope for such Member State to *suspend the application of certain concessions or obligations owed to the non-compliant trading partner*, as is appropriate in the circumstances.

Potential consequences of a breach

DTIC localisation policies (cont.)

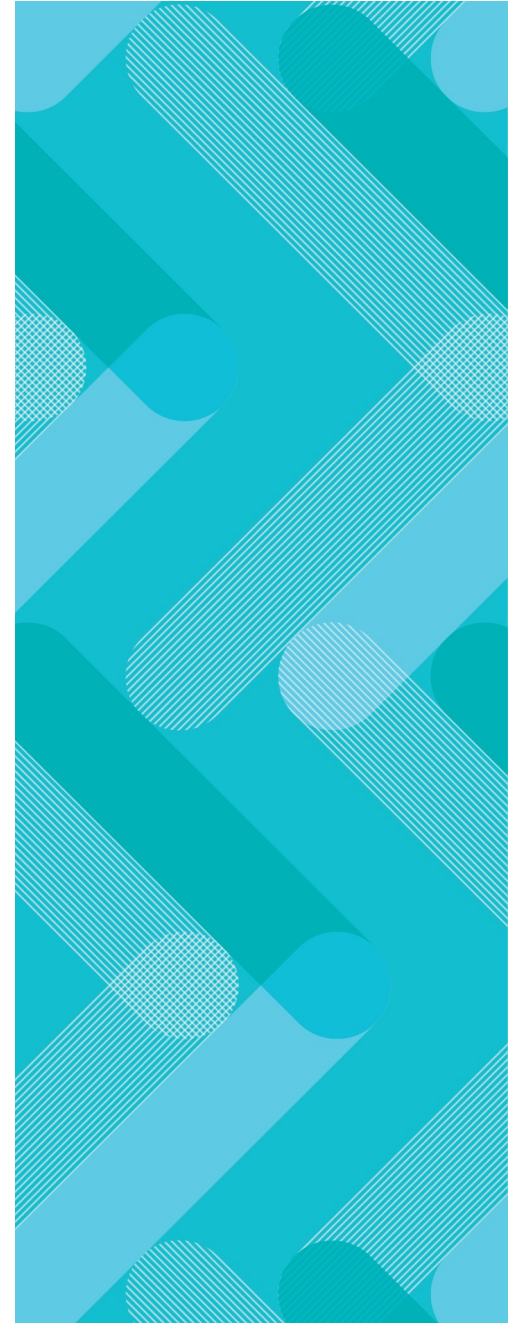
- If the implementation of these policies results in a breach of SA's obligations under the AfCFTA or the SADC-EU EPA, the injured trading partner could have recourse to the relevant *dispute settlement processes* outlined in the respective agreements.
 - AfCFTA's Protocol on the Rules and Procedures on the Settlement of Disputes:
 - State Parties which are unable to resolve a dispute through consultations, they may refer the matter to the Dispute Settlement Body; and
 - Request the establishment of a Dispute Settlement Panel for the purposes of settling the dispute.
 - The SADC-EU EPA:
 - The Parties should endeavor to resolve any dispute through consultations, failing which, the Parties may seek recourse to mediation.
 - Where the Parties have failed to resolve the dispute through consultations or mediation, they may request the establishment of an arbitration panel in order to settle the dispute.

Potential consequences of a breach

Broad-Based Socio-Economic Empowerment Charter for the Mining and Minerals Industry, 2018

- There are other industry-specific local content policies which have already been set out in greater detail and which appear to contravene the non-discrimination obligations detailed above.
- The most significant example is the Broad-Based Socio-Economic Empowerment Charter for the Mining and Minerals Industry, 2018 (**MCIII**):
 - Right holders will be unable to procure more than 30 per cent of their mining goods from foreign suppliers.
 - Right holders are precluded from contracting more than 20 per cent of their services from foreign suppliers.
- These provisions may constitute *contraventions of the national treatment principle* in Article III of the GATT and Article XVII of the GATS respectively.
 - By imposing the 70:30 minimum threshold requirements for goods and 80:20 minimum threshold requirement for services, the Department of Mineral Resources and Energy is implementing measures which *unlawfully discriminate* between domestic and imported goods and services. (*Japan – Taxes on Alcoholic Beverages (AB-1996-2)*)
 - The measures constitute a breach of the requirements imposed under the GATT, GATS and TRIMs which may result in other member states referring a dispute to the WTO's Dispute Settlement Body.

| Conclusion



Conclusion

- The South African economy was off to a buoyant start in the first quarter of this year: it grew by 1.1 per cent (which translates into an annualised growth rate of 4.6 per cent).
- According to StatsSA, the finance, mining and trade industries were the main drivers of output on the production (supply) side of the economy, while household spending and changes in inventories helped spur growth on the expenditure (demand) side.
- The trajectory may have been ruined by a combination of renewed Covid-19 containment measures and the recent civil unrest.
- It is therefore critical that the SA government implements measures which would promote investment (including foreign direct investment) in the sectors which were driving the growth.
- While the proposed localisation measures may have laudable objectives, they could have a materially detrimental impact on the economy.
- If the SA government intends to pursue the policy, it would be important to ensure that it is implemented in a manner which does not further suffocate the economy.

The contents of this publication, current at the date of publication set out in this document, are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

Herbert Smith Freehills South Africa LLP and Herbert Smith Freehills, an Australian Partnership, are separate member firms of the international legal practice known as Herbert Smith Freehills.

© Herbert Smith Freehills South Africa LLP 2021