

# A STRATEGY FOR ATTRACTING FOREIGN DIRECT INVESTMENT

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## 1. INTRODUCTION

Foreign Direct Investment [FDI] comprises one, often small, element of Gross Capital Formation of a country. This begs the question why FDI remains a preoccupation of researchers and investment agencies. As will be seen below, we argue that the importance of FDI to South Africa extends beyond the quantum of capital flows to other qualitative factors that may enhance development. In addition, the prerequisites of foreign investors put those factors that inhibit investment into relief against those that facilitate it. To the extent that the negative factors are addressed, domestic investment will also be encouraged.

The point of entry of the paper is the decision-making process of investors, based on the results of the National Enterprise Survey of South Africa and interviews conducted with existing and prospective investors. The paper examines the motivation to invest and some of the primary inhibitors to the process of investment. A strategy to attracting investment is developed based on different levels of investor prerequisites within the Southern African context, with the aim of moving beyond ignorance and expressions of interest to committed investment decisions.

Section two sets the scene for the rest of the paper, providing a description of the benefits of FDI and an examination of comparative inflows of FDI into a number of emerging markets. The section concludes with an overview of the South African Financial Account on the Balance of Payments over recent years. The third section briefly introduces the National Enterprise Survey and examines the results of the survey, as it presents a profile of foreign investors. Section four provides a classification of motivations for foreign investment and examines the South African experience in this regard. Section five examines the obstacles to entry, as highlighted by new foreign-owned firms, and to ongoing investment, as highlighted by existing foreign-owned firms. Based on the previous sections, Section six presents a scheme of the prerequisites of foreign investors and explains the suggested strategy to attracting FDI. Section seven concludes.

## 2. FOREIGN DIRECT INVESTMENT IN THE SA CONTEXT

FDI is but one element of foreign capital flows. Foreign private capital flows also encompass foreign portfolio investment, foreign purchases of domestic bonds, and bank lending. Private flows may be supplemented by official flows – which include sovereign grants, aid, and financial assistance from multilateral agencies such as the World Bank and the International Monetary Fund.

While the focus of this study is on foreign direct investment, it is important to note that although the various elements of capital - or net resource - flows are qualitatively different,

they are substitutable. Some countries – such as South Africa – may attract relatively small proportions of international FDI and official flows, but more significant shares of foreign portfolio investment. In many other African countries, FDI and portfolio investment may be negligible, but official flows are relatively high.

Foreign direct investment refers to net inflows of investment to acquire a lasting management interest (10 per cent or more of voting stock) in an enterprise operating in an economy other than that of the investor. FDI has three components: equity investment, reinvested earnings and short and long term inter-company loans between parents and foreign affiliates. However, unless there is an explicit transaction related to the reinvestment of earnings, official data relating to FDI flows tends to ignore this component.

Figure 1 shows South Africa's performance in terms of attracting foreign direct investment relative to other emerging economies – both prior to, and after the Asian Crisis. The country fares relatively poorly in terms of the average contribution of net foreign direct investment to gross capital formation. If South Africa had achieved a similar ratio of FDI to gross capital formation to that of Chile in the post-Asian crisis period, then the country would have enjoyed average net inflows in the 1998-99 period of R36 856 million [US\$6.3 billion] compared with actual net inflows [according to World Bank figures] of only US\$168 million.

While explanations for a country's success in attracting high levels of FDI involve the particular characteristics and location of the country concerned, there are also regional aspects that contribute to its attractiveness as an investment destination. Between 1980 and 1989, worldwide growth in foreign direct investment amounted to 30 per cent. Eighty per cent of these direct investment flows took place within the regional blocks of North America, Europe and Asia. It seems that investors within a region may be the principal source of FDI for that region. This may, in part, account for the strong performance of FDI in East Asia and Latin America, relative to Africa.

Crucially, FDI supplements domestic investment, and so facilitates higher domestic growth while accommodating increased imports. Currently, FDI flows make up some 10 per cent of gross fixed capital formation in developing countries world-wide (UNCTAD, 1999). For South Africa, the ratio of net FDI flows to gross capital formation reached a peak of 6,2% in 1997 (SARB, 2001).

However, the importance of FDI to developing countries, including South Africa, extends beyond the quantum of capital flows to other qualitative factors that may enhance development. These include: -

- The transfer of technology which may enhance domestic innovation;
- The transfer of management know-how and skills leading to the development of human capital;
- Access to markets otherwise denied the country;
- The stimulation of competition in the domestic economy, thereby enhancing productivity and reducing inflationary pressures;
- The integration of the domestic economy with international supply chains – thereby offering benefits of reduced costs of both wage and non-wage goods, improved economies of scale, and increased exports; and
- Opportunity to take advantage of complementarities between profitable FDI and domestic investment.

From this perspective, multinational corporations (MNCs) can be important agents in building and shifting a country's comparative advantages and should be considered part of the solution

to development, rather than the problem. Indeed, governments have generally changed their hostile attitude of twenty years ago towards MNCs to one of actively wooing MNC participation (UNCTC, 1992).

The balance of payments data for South Africa in Table 1 shows that since 1994, there have - in the aggregate - been positive net inflows of both direct and portfolio investment. A substantial part of the direct investment flows into South Africa during the 1990s that were not linked to privatization initiatives may have been re-investments arising from the re-entry of multinationals that had disinvested during the sanctions era. Some outward investment by South African-owned firms during the period may also have been based on re-investments into operations from which they had been displaced by sanctions.

Figure 2 reveals a fair amount of volatility from year to year. For example, net FDI inflows amounted to 6 per cent of gross capital formation in South Africa in 1997, and -5.3 per cent of GCF in 1998, recovering to 1.6 per cent of GCF in 2000. The high levels of FDI in 1997 were achieved with the partial privatisation of state assets: Telkom and the Airports Company among them.

One of the problems associated with the data on the financial account of the balance of payments is that the labels can be misleading. For example, FDI is associated with relatively longer term, committed capital, and with 'patient' investors (Maxfield, 1998). However, the IMF definition of FDI as the acquisition of ten percent or more of the shares or voting rights of the company, does not provide information regarding the long-term intention of investors. It has been suggested that the degree of persistence attributed to the FDI flows has been exaggerated, and that capital flows are fungible and highly substitutable. This is something repeatedly encountered in the literature - with MNCs generally being seen as 'footloose' (Kozul-Wright and Rowthorn, 1998). Hence an investor buying more than ten per cent of the equity of a company may hedge his/her longer-term risk exposure through some compensating financial transaction (Maxfield, 1998).

When viewing the balance of payments data it is worth bearing in mind that a range of motives may have stimulated the investment, hence simple assumptions about the longevity of capital flows based on balance of payments classifications should be avoided. Portfolio flows, for example, are not necessarily 'hot', and they may contribute to the expansion of investor horizons (Claasens, Dooley and Warner, 1995). Indeed, interviews with fund managers in London suggested that institutional investors generally take a long view with regards a particular country, and in the case of the recent turbulence in the markets, used the opportunity to increase their purchases of South African equities and bonds.

The equity flows into South Africa in 1997 represented close to 5 per cent of all equity flows into low and middle-income countries in that year. In 1999 South Africa's share was in excess of 11 per cent. This suggests that the return to shares on the JSE in recent years were considered competitive and that the country was seen to provide an opportunity for risk diversification by institutional investors. However, the increase in portfolio investment also reflects the global trend towards private capital flows becoming increasingly dominated by portfolio flows (World Bank 1997). Prior to the current global economic slowdown, international organisations such as the World Bank expected a continuing increase in global portfolio flows into equities (World Bank, 1997:22).

In early 2000, some market analysts contended that the "neutral" weighting of South African equities in most emerging market funds was around 8 per cent, and that most funds were invested to these levels. However, these weights of the emerging market funds provide a

broad indication of intent, at best, rather than an actual share of global portfolio funds. Global market conditions may lead to funds being ‘under-weight’ in the shares of a particular country. For example, although the neutral weight of South African shares may be 8 per cent, this could fall by a significant proportion – depending of market perceptions of the country (SG Cowen, 2000:2). It is also worth drawing attention to the fact that international investors tend to place great importance on liquidity, focusing principally on shares with a large market capitalization and high turnover. As a result, trading tends to be limited almost exclusively to the top forty – and more often the top 5 to 10 - South African shares in terms of market capitalization.

The anticipated growth of portfolio investment, and the potential negative consequences of portfolio flow reversal for the exchange rate and the economy, suggests that the strategic approach to foreign direct investment needs to be cognizant of the impact of portfolio flows. This will also have to take account of the possible impact on portfolio inflows into South Africa after the liberalisation of China’s stock markets.

### **3. A PROFILE OF FOREIGN INVESTMENT IN SOUTH AFRICA**

Based on the results of the National Enterprise Survey<sup>1</sup> the “typical” foreign investor is profiled. Because of the radically different environments that may have existed at the time of the original investment, a distinction has been drawn between the results of those firms that invested prior to 1990, and those foreign firms that invested during the past decade. A distinction has also been drawn between investors in the manufacturing sector and those in the services sector. These “profiles” are shown in Tables 3 and 4.

While a number of private consultancies and public agencies are actively trying to identify and nurture partnerships between South African and foreign firms, of the 54 foreign-owned operations surveyed which were established in South Africa over the past decade, 33 are 100 per cent foreign-owned. Amongst those firms with more than 10 per cent foreign ownership, the degree of foreign ownership is also above 75 per cent in most sectors surveyed. This suggests that a high proportion of foreign investments in South Africa have taken the form of acquisitions, rather than mergers or other partnership arrangements.

More recent investments in both the manufacturing and services sectors tend to be much smaller in scale – in terms of sales, employment and the fixed asset base. On the basis of the limited sample, it would appear that recent investors in the services sector are more likely to be invested in producer services than their more established counterparts.

Recent investors in manufacturing appear to export a significantly greater proportion of their production than those firms that invested prior to 1990. By contrast, recent foreign investors in the services sectors – while quick to begin exporting – earn relatively less of their revenues from exports, although this may be a function of their limited period of operation in the country. More recent investors were, on average, significantly quicker to commence

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<sup>1</sup> The National Enterprise Survey was conducted throughout South Africa by the Investment Study Team brought together by the Policy Co-ordination and Advisory Service Unit of the Office of the President. This was done on behalf of the Cabinet’s Investment and Employment Cluster at the beginning of 2000. The survey focused on the determinants of investment into plant and equipment but also questioned firms on business activity and outlook, financing investment, and broader socio-political issues. The survey captured the responses of some 1439 firms in South Africa of which 165 could be classified as totally or partially foreign-owned by virtue of the IMF definition (foreign interest in the company must be equal to or exceed 10 per cent of shares). The results of these firms provide the source of information for existing foreign investors. Permission from the Investment Study Team’s co-ordinator, Dr. Stephen Gelb, to use this data is gratefully acknowledged.

exporting than the foreign-owned firms that invested during the era of import-replacement. Exports per employee for foreign-owned manufacturing firms that were established during the past decade are more than double those of earlier investors. Africa is the most important export destination for firms investing over the past decade, whereas exports to industrialized economies are higher in the case of older firms.

Capital expenditure figures for the past two years also suggest that recent investors are more inclined to maintain and increase their fixed capital stock than their more-established counterparts. The scale of operations amongst manufacturers that commenced operations before 1990 varies greatly – with significant differences between the mean and median value of fixed assets. More-recent investors in both the manufacturing and services sectors have fewer plants or service outlets than their longer-established counterparts, with the former tending to be single plant or outlet operations. This may simply be a function of the period that firms have been operating, but it could also provide some indication of the impact of new technologies on firm structure.

While the mean capital cost per employee [a rough measure of the investment required to create a job] is higher for more recent investors, the fact that the corresponding median capital costs per employee are less than for operations established before 1990 suggests a high degree of variability in this measure. For most recent foreign investors, the capital cost per job created has been lower than for pre-1990 investors.

While longer-established foreign manufacturers have, on average, invested significantly more than later investors, their ratio of total capital expenditure to fixed assets is less. Whereas longer-established manufacturers spent 28 per cent of their total investment on vehicles, recent investors only spent one tenth of that proportion – focusing instead on investments in other machinery and equipment, and the purchase of land, buildings and physical facilities, where average investments were higher. Recent manufacturing investors spent comparatively less on computers and software, and on “other” investments. In general terms, however, total investment spending was low – with median capital expenditure for foreign-owned manufacturing operations that commenced operations before 1990 less than R1 million per annum and after 1990 around R60 000 per annum.

Amongst foreign investors in the services sectors, median annual capital expenditure was around R860 000 for pre-1990 investors and about R165 000 for service firms that commenced operations in the past decade. Average investment spending by more established service firms was focused to a greater extent on purchases of computers and vehicles than those service operations that were established in the past decade. By contrast, recent investors spent a higher proportion of their capital expenditure on land and buildings, and other machinery and equipment.

Table 5 indicates the source of finance for investment. The survey reveals that all firms tend to rely on retained earnings or internal funds for investment expenditures, with foreigners more reliant on internal funds. In both foreign and locally owned firms, loans from South African banks were rated as the second most important source for finance for capital expenditure, after retained earnings.

#### **4. THE MOTIVATION TO INVEST**

Any attempt to design policy prescriptions that result in an increase in foreign direct investment into South Africa needs to be based on an understanding of what motivates

investors to make investments in foreign countries. Rational investors are likely to base decisions on where to invest on the quality of the investment opportunity, the anticipated returns and the ease with which the investment can take place, adjusted for the foreseeable and unforeseeable risks that will prevent such returns from being realized. Policies aimed at increasing the level of foreign direct investment need to attempt to market opportunities and raise the potential returns, while reducing obstacles and risks associated with such investments.

The assessment of the potential returns to the investment opportunity is likely to take into account a range of factors, including the size of the market; expectations of growth in aggregate demand; strategic gains in market share (on a national/regional basis); expected changes/ volatility in interest rates and exchange rates; which may affect financial costs and export earnings; the cost and availability of inputs; and the level of protection from foreign competition.

It is generally accepted that analysis of FDI should begin with the theory of industrial organisation. Firms begin by serving a local market, and export to other regions and countries from their local base. Firm size and market penetration appears to be important for expansion of production facilities in new areas. It appears that generally, when sufficient sales have been achieved in the new market, it becomes feasible to set up production facilities large enough to exploit economies of scale. While this description is of an ideal type – it does underscore the importance of growth and size of market in contributing to the motivation for direct investment. Indeed, this motivation alone in many cases proved to be decisive in leading to wide-scale investment in China, even where other market research was inadequate (Economist, 1999).

The FDI decision is undertaken to generate profit by creating or defending a market or gaining control of inputs (Kenworthy, 1997). One possible classification scheme of such motives is that of Dunning (1997) who classifies motives for direct investment as primarily resource-seeking; market-seeking; efficiency-seeking; or strategic-asset-seeking. These motives are further outlined below:

- Resource-seeking investment is usually directly tied to the presence of natural resources or their processing. This is generally seen as locationally-fixed investment, although processing activities may be more mobile than extraction activities. Governments are generally seen to have significant bargaining power over MNCs where this type of investment applies. Policy approaches to mineral rights and licenses are likely to be significant issues in this kind of investment. The investment by the Canadian firm Placer Dome in South Africa's mining sector may be seen as falling under this motive.
- Market-seeking investment seeks to access individual or regional markets. South Africa's manufacturing base is widely diversified which suggests that there may be more limited opportunities for market capture. The disparities in income between the SADC countries may also work against the regional market motive. Historically low growth, off a low base, in SADC countries, may also militate against the significance of this factor, unless higher growth levels can be achieved and sustained. Interviews conducted in London revealed the perception that while association with regions such as the European Union enhanced other emerging market's prospects, South Africa did not necessarily benefit from its association with SADC. The "FDI Confidence Audit" conducted early in 2000 by management consulting firm A.T. Kearney reinforced this perception. It concluded "South Africa's first challenge is to define its identity as an investment destination distinct from the rest of Africa" (A.T. Kearney, 2000). This suggests an important potential role for South Africa, both in terms of its leadership role in SADC and in the marketing of the region.

- Efficiency-seeking or cost-reducing investment is undertaken by MNCs to provide more favourable cost bases for their operations. For example, source factories may provide specific components in ‘globally rationalised plants’. Efficiency-seeking FDI tends to be located in countries with skilled, disciplined workforces and good technological and physical infrastructure. The recent expansion of the Mercedes Benz plant in Port Elizabeth by the foreign parent Daimler Chrysler appears to fall into this latter category. Incentives can make the difference at the margin between otherwise similar locations for this kind of investment. Countries attempting to outbid other competitors in this way may find themselves subject to ‘incentive inflation’.
- Strategic-asset and capability-seeking investment aims at protecting or advancing the global competitive advantages of the MNC. These kinds of investments tend to be locationally specific. For example, the recent acquisition of Safmarine by the Danish company, A P Moller, can be seen as falling into this category, earning them access to a Southern shipping line. This category of investment also suggests the need to expand investor horizons to the African continent, by providing reliable information.

While this scheme may provide a useful means of categorising investment, knowledge of the country appears to be crucial to the location decision made by MNCs. For this reason, MNCs often appear to expand first to neighbouring countries (Kozul-Wright and Rowthorn, 1998). Countries about which there is little first-hand knowledge remain at the periphery of the evaluation of location decisions and peripheral regions are subject to the ‘ignorance and prejudice’ (Morgan, 1973: 21) that accompanies remoteness. Investors are likely to overestimate risks or underestimate opportunities in the periphery; which may contribute to the volatility of income in the periphery, as well as the larger amplitude of the business cycle associated with it.

Various interviews with foreign investors suggest that a favourable disposition of the decision-makers toward South Africa, and some (limited) first-hand knowledge of the market, were crucial to locating the investment in South Africa. A “subjective preference” for the country was necessary to ensure willingness and desire to identify business opportunities in the country, and to persist with the search process. However, this did not obviate the need to deliver shareholders an acceptable return on their investment – which from interviews appears to fall within the range of a 16 to 20 per cent return on capital employed. It is worth noting that while these “hurdle rate” returns are lower than that applied by many local firms in their investment decisions over the past decade (often around 30 per cent), the percentage returns required would have to be significantly higher in local currency terms in periods of Rand-weakness.

The necessity of a subjective preference for South Africa suggests that an important element of any investment promotion effort should be the exposure of decision-makers to South Africa through holiday and business tourism, and highlights the importance of such efforts as the 2006 Soccer World Cup-bid. The “broadcast” effects associated with investments by large, recognized multinational corporations should also not be ignored. In this regard, the appointments to the International Investment Council are a positive development, and could go some way towards reassuring smaller foreign investors, provided that the personalities involved, and the corporations that they represent, are seen to be actively investing in South Africa themselves. Given the consolidation happening in the global economy at this time, the short-term outlook for significant, non-privatisation foreign investment inflows is not necessarily encouraging.

This links to the issue of investor perceptions of South Africa. Even if investor perceptions are not accurate, they drive or inhibit the decision to invest (Fine, 1996). Hence ways in

which inaccurate or incomplete perceptions may be addressed or supplemented by more accurate information need to be considered. Foreign observers repeatedly raised the issue of South Africa's 'bad press', suggesting the need for better management of information to important players in the media. Kindleberger (1987) suggests that the information horizons of investors expand and contract in response to world events. Accessible information regarding the country and its opportunities may be a way of expanding investor horizons to include South Africa.

Analysis of the National Enterprise Survey provides some broad indication of the primary motivation of foreign investors for investing in South Africa. This is shown in Table 6. Firms whose regional turnover [domestic sales and exports to Africa] accounts for 90% or more of their total turnover are assumed to have been motivated to invest by market-seeking considerations. Firms that either export 70% or more of their turnover to non-African destinations, or whose annual turnover is more than R1000 million are assumed to have been motivated primarily by considerations of efficiency or cost reduction.

The firms that are clearly motivated primarily by a desire to access the local and regional market account for 67 of the 165 firms surveyed, while those that are probably motivated by efficiency or cost-reduction objectives make up 12 firms. Remaining foreign-owned firms are likely to be motivated by a combination of factors. The market-seeking motive could be ascribed to about 58% of firms interviewed separately from the survey process, with efficiency or cost reduction motives accounting for around 24% of firms, and resource-seeking and strategic asset-seeking motives each accounting for about 9% of firms interviewed.

It is clear from Table 6 that there are significant differences in the scale of the operations, and level of investment of firms depending on their primary motivation for establishing operations in South Africa. The investment behaviour of market-seeking firms is likely to be dependent on growth in the regional economy to a greater extent than firms that are established primarily to supply the world market. *Given the predominance of market-seeking firms, policies that give rise to more rapid economic growth within the regional market could prove to be more effective in increasing aggregate fixed capital formation than other initiatives.* Conversely, this points to the negative effect of developments in Zimbabwe on direct investment flows to South Africa.

To the extent that market seeking continues to be the primary motivation for the entry of new foreign-owned firms, this also has implications for investment incentives. Incentives granted to firms motivated by considerations of market access are likely to be wasted, because they will not be a significant factor in the investment decision. The further lowering of average tariff levels is also likely to impact on the scale of this type of investment in the future, as there may be a greater incentive for multinational corporations to invest in distribution operations rather than production facilities.

Attempts to shift the balance of new FDI away from projects motivated primarily by market seeking towards ones that have efficiency or cost-reducing objectives will need to incorporate measures that reduce production and/or distribution costs to levels that are competitive internationally. This approach may have to rely on incentives that effectively reduce costs and/or raise returns. Although there was relatively greater awareness and use by foreign investors of the Tax Holiday Scheme that was in place until September 1999, discussions with investors suggest that a more extensive package of incentives – such as the Motor Industry Development Programme - will be required to attract more foreign investments that are motivated by efficiency-seeking objectives.

Where FDI decisions are motivated by considerations of market access rather than efficiency or cost reduction, South Africa's comparatively diversified industrial base and the relatively small national and regional market size places certain constraints on the entry of foreign firms. As a result, risk-averse foreigners with limited knowledge of local market conditions tend to favour partnership arrangements with established local firms, and to undertake fairly limited initial investments in order to establish a market presence.

A significant proportion of the recent FDI inflows have involved the acquisition of equity stakes in privatized parastatals. From a qualitative point of view, the direct economic impact of such flows on aspects such as employment creation is likely to be different to other investments in "greenfield operations". To the extent that the sale of state assets is expected to accelerate in coming years, the impact of associated direct investment flows on employment creation and foreign exchange earnings will be muted. Much will therefore depend on how the earnings from the sale or partial sale are used, and over the longer term, what efficiency gains are made by the privatized parastatal as a result of the investment by the foreign corporation.

The most important reason cited by foreign-owned firms for the increase in capital expenditure over the two years prior to the survey was to raise efficiency. An improvement in efficiency may lead to strategic gains in market share, which is supported by the second most important reason, to improve product quality. Local firms seem primarily motivated by expected sales growth and product improvement to increase their capital expenditure.

It has been suggested that the expansion of the operations of foreign firms in the country is important for the manifestation of the benefits of direct investment. While foreign firms may not continually supplement their initial investments with additional capital inflows, the extent of their direct investments may increase substantially as a result of retained earnings, local borrowings, or the sale of equity.

## **5. OBSTACLES TO FOREIGN DIRECT INVESTMENT IN SOUTH AFRICA**

The focus of the National Enterprise Survey is on the investment behaviour of firms that are already established in South Africa, rather than on new entrants. As such it identifies obstacles to the expansion of existing investments, but does not provide much insight into the difficulties encountered by foreign investors making direct investments in South Africa for the first time. For this reason, the Survey was supplemented by a series of interviews with investors that have either made initial investments recently, or who are in the process of considering investing in this country for the first time. We review these responses and those of the firms surveyed by the NES below.

### **5.1 Obstacles to the entry of new foreign-owned firms**

Generally, all of the companies interviewed had already been "exposed" to South Africa as an investment possibility, and had identified some investment opportunity here. The obstacles discussed in this section were therefore encountered in the process of making the investment, and were usually less of a constraint in cases where the company either had an experienced private consultancy, or one of the provincial investment promotion agencies to assist it. Interestingly, outside of investments into the motor industry, where the Motor Industry Development Programme was viewed as a crucial factor in the investment decision, few of

the investments were motivated by the incentives available at the time. While a number of recent investors did make partial use of the Tax Holiday Scheme, none of them qualified for the labour component, and few of them believed that the benefits derived were significant.

For the most part, the difficulties encountered by new entrants stem from a lack of knowledge and understanding of the prevailing regulatory, administrative and business “culture”, and a feeling of being “unwelcome outsiders”. This is one of the reasons why mergers and acquisitions are the favoured method of entry. While larger MNCs usually have extensive experience of establishing new operations in other countries, and are prepared to contract consulting firms to assist them, smaller investors are often unwilling to pay the high costs that may be associated with such assistance. Some form of subsidized “hand-holding” may be appropriate in these circumstances.

The largest category of obstacles relates to navigation through the array of regulatory and administrative requirements - from company registration, to the development of Workplace Equity plans, to the identification of appropriate premises. Because recruitment of appropriately-skilled and qualified local personnel emerges as a significant obstacle to getting projects up and running, the difficulties in obtaining work permits for expatriate employees from the Department of Home Affairs was viewed with frustration by most investors interviewed, and some of the firms interviewed stated that problems had almost led to their withdrawal.

Since new foreign entrants invariably feel less secure than their local counterparts, uncertainty arising from different interpretations of the provisions of new legislation acts as a greater disincentive to investment. Fears that the newly established firm would fall foul of the Competition Act, and delays in getting Competition Board approval, were identified by a number of investors. Similarly, while there was little opposition to the concept of economic empowerment of previously disadvantaged segments of the population, uncertainty over what constitutes “empowerment” was identified as an area of concern. There is a perception that different interpretations of “empowerment” are used in a subjective manner to exclude certain foreign firms and consortia from state and provincial government, and parastatal, tenders.

## **5.2 Obstacles to ongoing investment by foreign-owned firms**

The NES surveyed firms on a wide range of possible obstacles to investment, including crime, labour relations, interest rates, tax rates and uncertainty.

Although there is some variation, the survey results reveal largely similar concerns by locally and foreign owned firms alike. Table 7 summarises the results, indicating the level of response for the most important factors (the percentage refers to those respondents rating the factor as an ‘insurmountable’ or ‘severe’ obstacle). The data seem to suggest that local firms rate more obstacles as insurmountable than foreign firms. While it is difficult to establish the reasons, two possibilities are that foreigners have a comparative basis against which to rate these obstacles. In addition, it may be that they are pleasantly surprised with the reality here, given the bad press coverage of the country.

Crime and related social problems are identified as the most important obstacle to capital expenditure. While political instability may be a concern for foreigners outside the country, crime is the most pressing concern for investors within the country. Generally smaller firms, irrespective of ownership, registered greater concern regarding crime.

High and fluctuating interest rates are rated the second and fourth most important problems by locally owned firms. Fluctuating interest rates appear to be less important to foreign-owned firms than the level and the variability of the exchange rate. The significance of the exchange rate could be due to the imported inputs required by foreign owned firms and may also reflect the currency effect on repatriated profits. Repatriated profits tend to be undermined by declining Rand-values.

Labour regulations – particularly as they relate to the implementation of new labour laws - seem to be of equivalent universal concern to all the respondents. This is one of the areas where clearer information would be useful. Foreign investors indicated a high degree of uncertainty regarding the extent to which they might be affected by the labour equity legislation, for example. The lack of clarity regarding the implementation of such legislation is of concern, as is the uncertainty associated with such legislation. See Table 8.

While the new labour regulations did not appear to be a primary reason for reduction in existing employment levels, the effect of the labour regulations can be seen in their impact on the hiring decisions of firms. The labour regulations appertaining to firing or dismissal procedures are rated as a significant inhibitor of hiring *new* employees by all firms. Foreign firms rate inadequate tax incentives above the company tax rate as an obstacle to investment. By contrast local firms indicated that a lower company tax rate would be the most encouraging tax change for increased investment. Foreign firms rated a tax exemption on profits based on capital expenditure and higher depreciation allowances on machinery and equipment as more encouraging for capital expenditure than a lower company tax rate.

Foreign firms seemed to have better knowledge of the DTI Tax Holiday Scheme, with just over 50 per cent of them indicating they were aware of the incentives, compared to 23 per cent of local firms. However, only a quarter of the foreign firms who knew of the incentives made use of them.

Part of the attitude of firms towards regulation involves their perceptions of government and their understanding of business problems. In the survey a range of questions regarding the firms' perceptions of government, in terms of understanding the problems of business and policy consistency were asked. The responses of foreign and domestic firms are captured in Table 9.

The generally negative perceptions that firms have of government suggest that there is room for better communication between the government and the business sector. In particular, striving for greater transparency and ensuring that there is clear, unambiguous information available can address the perception that there is a lack of predictability of policy.

Another area where institutional practices and regulation may inhibit business activities, and - in the long term - affect decisions regarding investment, is in the area of trade laws and regulations, and customs practices. These are shown in Table 10.

Delays of clearing imports through customs appears to be a concern of some of the foreign firms, as is the improper application of tariff and custom rules by South African officials. Where goods are misallocated in terms of tariff classifications, this can imply additional costs to the firm. Imposition of tariffs by other countries is also rated as a concern of some foreign firms. On the other hand, SA antidumping action to stop sale of foreign goods below cost price is seen as a major benefit by some foreign owned firms

Sound and reliable infrastructure is often mentioned as an attraction of the South African economy. The survey asked firms their impression of the reliability and cost of infrastructure services. Their ratings are shown in Table 11.

The data suggest that while the reliability of electrical power has a beneficial impact on the operation of foreign and local firms alike, the cost of power is seen as generally more beneficial by foreign than local firms. However, both the cost and the reliability of postal services are seen as having a negative effect on both foreign and local firms alike. In the same way, while neither the cost nor the reliability of the telephone services is seen as beneficial to firms' operations, the reliability of the internet, which presumably uses these telephone services are rated quite positively.

## **6. TOWARDS A STRATEGY FOR ATTRACTING FOREIGN DIRECT INVESTMENT**

Based on the literature survey, the national survey of enterprises and a number of interviews with recent investors, the study has provided insights into the processes and motivations of new and continuing foreign investment in South Africa. This section highlights some of these insights.

The study supports the general perception that South Africa needs to be marketed to foreign investors. We suggest that the approach needs to be twofold. Firstly, foreign investors are more likely to consider South Africa as a destination if they have had some prior exposure to the country. This raises the importance of attracting tourists and global events, in order to facilitate the development of a preference for South Africa. While broad, general promotion activities are to be encouraged for this reason, they are unlikely to be sufficient to secure foreign direct investment. In addition, foreign investors need to be courted with targeted investment opportunities. Exposure to specific opportunities is more likely to encourage commitment on the part of those foreign investors positively exposed to South Africa. This suggests the need to encourage the process of identification of joint investment opportunities, involving foreign and local investors alike.

The study reveals that the *quality* of investment currently being attracted to the country is disappointing. This suggests that a new strategy needs to be adopted to attract investment. We suggest that the policy strategy should be molded by a better understanding of what motivates investors to make investments in different locations, as set out in section 4 above. While it is accepted that foreign direct investment is not necessarily superior to domestic investment, the study points to the need to encourage joint ventures between domestic and foreign firms and investors, so as to enable South African products entry into global supply chains.

The type of foreign investment currently taking place appears to be motivated primarily by access to the South and Southern African markets. While this is encouraging to some extent, given that the regional market remains relatively small and disrupted by conflict, it also suggests that left unmanaged, this motivation may be limited. This underlines the need for a strategic approach that aims to encourage investment through the identification of opportunities and facilitation of matchmaking between South African and foreign entrepreneurs.

This has implications for the 'incentive-based' approach to attracting foreign investment:

- i. While incentives may sweeten the deal, if the primary motivation for investment is market-seeking then the investment is likely to take place regardless of incentives. This suggests that the resources used for incentives could be better employed elsewhere. While some countries appear to have had success with the use of incentives, the economic and structural circumstances have been different to those of South Africa, and the causal links are therefore not nearly as clear as the proponents of incentives make out.
- ii. While the market-seeking motivation may currently dominate foreign investment, identification of specific opportunities may encourage efficiency-seeking as well as further market-seeking investment. Identification of specific opportunities is likely to require 'match-making' between domestic and foreign firms and investors. In order to encourage the identification of such opportunities, incentives for the entrepreneur, who identifies, facilitates and brings investment to fruition, may be required.
- iii. Encouragement of scale investment by means of an incentive package is likely to only be successful if it is undertaken on a scale similar to that of the Motor Investment Development Programme. In some cases, tariff-protection may also be required. Given current international trends determined by the World Trade Organisation, such a move may not be politically expedient. In addition, encouragement of investment through incentives may lead to 'incentive-competition' with other countries.

Figure 3: Elements of a Strategy for Attracting Foreign Direct Investment

<b>Strategy Element</b>	<b>Associated Function</b>	<b>Responsible Agencies</b>	<b>Anticipated Invested Response</b>
Development of subjective preference for South Africa	Marketing of South Africa	Investment promotion agencies, Communications agencies	From ignorance to awareness
Reduction of risks associated with investment in South Africa	Regulatory, institutional	Policy-makers and administrators	Expressions of interest
Investment opportunity identification	Entrepreneurial	Partnerships between private sector and public sector	Committed investment

Figure 3 is discussed below in some detail. Briefly, at the first and broadest level, there is a need for marketing the country, so that a subjective preference for South Africa is nurtured among investors. At the regulatory and institutional level, reduction of perceived risks is required. Above all, this requires widespread and accessible dissemination of information concerning regulations. The third important - and in our view neglected - requirement of would-be foreign investors is the identification of specific investment opportunities.

Each level encompasses different types of support and assistance, and requires different skills. The most appropriate provider of support should therefore be determined accordingly.

### **6.1 Level 1: Developing a preference for South Africa**

The base requirement of awareness of, and a subjective preference for, South Africa requires a coordinated marketing and communication strategy that seeks, first and foremost, to ensure that potential investors are enticed to visit South Africa. This would include elements such as: -

- i) The provision of basic information about South Africa and its economy;
- ii) A proactive communication strategy targeted at the most influential foreign financial print and electronic media that aims to correct misperceptions of South Africa, and to develop a positive image of the country;
- iii) Expanded marketing of South Africa as a business and holiday tourism destination; and
- iv) Enhanced efforts aimed at securing major international sporting and cultural events that attract large numbers of foreign visitors and which “showcase” South Africa.

Incentives to attract investment can play a role in indicating that the country is “open for business” and that it welcomes foreign entrants. However, with the exception of the Motor Industry Development Programme which appears to have played a crucial role in the locational choices of foreign firms in the motor and components industries, the incentives that have been available do not appear to have played a significant role in most of the investment decisions of the firms interviewed. At best they were viewed as providing some compensation for the risks associated with investment in South Africa.

Incentives tend to be viewed with greater importance by those involved in marketing South Africa – in part because it provides them with something tangible to “sell”. However, a projects-based focus that identifies specific opportunities and then seeks to match local firms with foreign ones is likely to prove more effective than broad “country marketing” based on incentives. If the incentive approach is to be followed, it cannot be the only element of a strategy to attract FDI to South Africa.

### **6.2 Level 2: Reducing the risks of investing in South Africa**

Responsibility for the risk reduction category rests largely with government, and encompasses aspects such as:

- i) A high degree of policy consistency and predictability – especially as it relates to government procurement, black economic empowerment, competition, and affirmative action policies;
- ii) Relatively equal treatment of foreign and local firms;
- iii) Access to, and high-level service from, specially identified and trained officials in relevant government departments; and
- iv) The commissioning and provision of market information on narrowly defined sectors.

A number of new pieces of legislation that impact directly on the business sector have been promulgated in South Africa in recent years. Because foreign investors in South Africa generally feel more insecure than their local counterparts, “subjective” elements in such

legislation increase the risks associated with investment, and give rise to perceptions amongst them of being “unwelcome” and “discriminated against”. A reduction in the scope for subjective rulings and interpretations in such legislation would reduce the risks faced by foreign investors.

Risks would be further reduced if foreign investors had improved access to officials in key government departments. Such officials should be trained to provide consistent guidance and appropriate and prompt support to potential investors. It may be necessary to designate personnel, who are sensitized to the need for South Africa to attract foreign investors, and who are appropriately trained to deal with potential foreign investors. The Department of Home Affairs in particular should be at the forefront of projecting a professional and positive image to potential investors.

Almost all of the foreign firms interviewed had had a negative experience in trying to obtain work permits for expatriate employees that were deemed necessary for the operation. While the concerns over illegal immigrants is understood, the unwillingness to grant foreign investors work permits on the grounds that the skills should be available locally is both insensitive to the needs of foreign investors and counterproductive. Given the costs that are usually associated with employing expatriate skills, there is, in most cases, a built-in incentive for such imported skills to be substituted with local skills once the operation is up and running and skills transfer has taken place. It makes little sense to put foreign investment projects at risk by refusing to grant work permits to key personnel. The procedures by which permits are obtained also need to be reviewed to eliminate lengthy delays. Some form of pre-approval by foreign embassies and/or other appropriate organizations should be considered.

The role of the Department of Trade and Industry in this process should be to develop and manage the strategic approach to investment in South Africa, from both local and foreign sources, by establishing the grounds rules for and administration of the proposed commission/incentive package and providing sectoral information to the market at reasonable cost. Information such as the size of an industry, the description of the supply chain, etc. is information that could reduce costs of entry and could also enable identification of opportunities. While the Department of Trade and Industry could commission these kinds of sectoral reports as and when deemed necessary, the cluster reports could provide a very useful starting point.

### **6.3 Level 3: Targeting specific projects for foreign and local investment**

Expressions of interest are often wrongly taken to mean that there will be investment. In order to take the decision beyond awareness and interest to committed investment, it may be necessary to assist with the identification of niche investment opportunities. This will require an entrepreneurial approach that combines sectoral and technical knowledge with an awareness of business decision-making processes, and an ability to identify and bring together potential partners. The nature of this activity is not suited to an administrative and regulatory approach. Instead, what is required are “entrepreneurial matchmakers” who actively seek out investment opportunities, and who bring together appropriate partners in new ventures.

Where joint venture opportunities are identified, both local and foreign interest is likely to be engendered. This approach has several advantages as it involves supporting local investors in joint ventures with foreigners by exposing local initiative to the global market. This approach is likely to harness the beneficial aspects of foreign direct investment such as transferal of skills, etc. most effectively. While any one project may not meet the highest criteria in job

creation, for instance, it does have the advantage of allowing South African producers access to global supply chains, which is likely to enable expansion of market share.

The identification of investment opportunities is generally seen as an entrepreneurial skill, and the matchmaking process is time consuming and resource intensive. This suggests an opportunity to utilise private sector expertise to encourage the identification of new projects designed to harness foreign direct investment. Both the provincial investment promotion agencies and independent consultants could be offered a commission based on various criteria, such as perhaps the size of the investment, or the number of jobs created. Commission payments could be in tranches - subject to investment being undertaken and sustained. This approach has the advantages of allowing entrepreneurs, in conjunction with consultants, to identify investment opportunities in the fields in which they have expertise and in which they perceive opportunities

It is likely that different sized foreign firms may require different levels of support and encouragement to invest in South Africa. While large international firms are likely to rely on their own consultants or in-house expertise to assess the viability of investment, they may require access to individuals at the Department of Trade and Industry to provide reassurance and answers to particular questions. Medium and small sized firms are likely to require more information regarding the scope of the investment and help regarding regulatory and institutional regulations. However, it is suggested that regardless of the size of the firms, a certain key effort in terms of the marketing of the country and provision of sectoral information is likely to be required, as suggested by the pyramid illustration above. Provision of these kinds of services should hence be the focus of government input into the process of encouraging foreign direct investment.

## **7 CONCLUSION**

Aside from the privatization of states assets, which will no doubt attract some foreign interest, FDI is unlikely to increase substantially in the future if the trends of the past and present continue. Some of the factors contributing towards the relatively low levels of FDI inflows include the poor growth performance and political instability in SADC; the small size of local and regional markets for many products and services; and the relatively limited apparent investment opportunities, given that South Africa is industrially diversified, with generally good provision of infrastructure.

Attempts to address the present, unfavourable situation need to be based on an understanding of the motives underlying the location decisions of foreign investors. At present, foreign investors who invest in South Africa are motivated predominantly by market-seeking objectives. As is the case with most domestic investment, FDI motivated by a desire to expand markets will benefit from stronger growth of the South African and regional markets, but is likely to be relatively insensitive to fiscal incentives.

A multi-tiered strategy that seeks to move more foreign investors from their present position, which is largely characterized by ignorance, through expressions of interest, to committed investment in South Africa is therefore proposed. This requires that we not only develop a more effective communication strategy, and expand attempts to develop a subjective preference for South Africa, but that we also reduce the risks associated with investment through more coherent and consistent policies. We also need to recognize that it is projects, rather than countries, into which investment is ultimately made.

It is in the identification, and communication, of such potential projects that current inward investment promotion efforts are – in our view – least effective. An important element of this strategy is therefore the greater involvement of “entrepreneurial match-makers” from the South African business sector in identifying projects that have the potential to attract foreigner investors.

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