

POLICY DETERMINANTS FOR FDI<sub>s</sub> IN SOUTH AFRICA

by

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## Acknowledgement

This research interrogated the impact of South Africa's macroeconomic policies in respect of their attractiveness to inflow FDIs. The study critically examined the pre-apartheid trade and investment regime, the transition to democratic rule, and the post apartheid period, up until the first half of 2007. The empirical study covered both policy makers and foreign direct investors in South Africa, in a research that found the policy framework to be counter-productive.

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## Declaration of originality

I declare that 'POLICY DETERMINANTS FOR FDI IN SOUTH AFRICA' is my own work and that all sources that I have used or quoted have been indicated and acknowledged by means of complete references.

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Aregbeshola R. A

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## Abstract

The effectiveness of South Africa's policy framework towards attracting FDI has been questionable. Determined to redress the instabilities created by the apartheid regime, the Government of National Unity (GNU) commissioned the Macroeconomic and Research Group (MERG), and charged it to devise appropriate policy reforms and intervention mechanism to address the shortcomings.

This research critically interrogates the effectiveness of government's policy reforms towards attracting FDI, especially the impacts of the Reconstruction and Development Programme (RDP), the Growth, Employment and Redistribution (GEAR) initiative and the Accelerated and Shared Growth Initiative of South Africa (ASGISA).

This research concludes that the policy determinants for inflow FDI have been self-defeating. Also, it was found that necessary reforms would have to be conducted to correct some of the shortcomings of the macroeconomic policies, as a way of creating an environment that is capable of attracting greenfield investments (FDI) to South Africa.

**Key words:** Foreign direct investment (FDI), macroeconomic policy framework, attracting inflow greenfield FDI, effectiveness of macroeconomic policies, South African trade and investment policies.

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# CHAPTER ONE

## INTRODUCTION AND BACKGROUND TO THE STUDY

### 1.1 Introduction

It is almost impossible for any nation state to thrive in isolation. In reality, nation states survive on resources that are generated locally; and obtain from abroad those resources that are not available locally but are crucial to their survival and growth (Ghauri & Buckley, 2002).

According to Hill (2007:167), "... common sense suggests that some international trade is beneficial. For example, nobody would suggest that Iceland should grow its own oranges." Hill (ibid) further observes that the economic views of Smith, Ricardo and, Heckscher-Ohlin explain the convincing merit of international trade even as far as the production of those goods and services that are locally possible is concerned, "The theories of Smith, Ricardo and Heckscher-Ohlin go beyond this commonsense notion, however, to show why it is beneficial for a country to engage in international trade even for products it is able to produce for itself."

More so, international investment, a better form of international trade (WTO, 2008) allows for the efficient allocation of global resources in order to reap comparative location specific advantages in the production of goods and services (Steers and Nardon, 2006). This situation suggests that it may be justifiable for nation states to specialise in the production of those goods and services that would yield locational comparative advantages and import those goods and services that would yield comparative disadvantages. This process, among others, appears to have enhanced international trade and foreign investment.



In order to reap the full benefits of international trade, the necessity of trade liberalisation to some degree, was discovered by the world regulatory bodies to be essential (Johnson and Turner, 2004). This process was aimed at facilitating the easy movement of factor inputs and finished products among nations, to ensure that the production of goods and services take place freely across borders - wherever investors perceive these activities to yield comparative locational specific advantages (Anderson, 2005, Rivera-Batiz and Oliva, 2003). This process has largely contributed to the process of globalisation in recent times (Steers and Nardon, 2006).

Globalisation augments foreign direct investment (FDI) through; inter alia, the agency of the General Agreement on Tariffs and Trade (GATT), and since 1995, its successor, the World Trade Organisation (WTO) (Johnson and Turner, 2004). These organs enhanced the establishment of regional trade blocs like the European Union (EU), The North American Free Trade Agreement (NAFTA), The Economic Community of West African States (ECOWAS) and the Southern African Development Community (SADC) to name but a few, by gearing their efforts towards a noticeable reduction in all forms of obstacles to the global production and marketing of products and services. This initiative has facilitated both free trade and FDI in recent years (Hough, Neuland and Bothma, 2003).

## **1.2 Preliminary literature review on foreign direct investment (FDI)**

Some researchers support the notion that FDI contributes to the productivity and growth of local enterprises. Blomstrom and Sjöholm (1998) are of the opinion that the productivity and growth of local enterprises could be achieved through spillover effects/externalities resulting from FDI.

This is achieved as the multinational enterprises (MNEs) either introduce superior technology or through the marketing activities of MNEs that affect the market

equilibrium - forcing local operators to act in such a way that they can retain their original market shares. Graham and Krugman (1995) indicate that competitive enterprises (MNEs) contribute to productivity and growth of the host nation by infusing technology, labour skills, management methods, and training into the host economy.

Empirical research shows that FDI affects the economy of a host country in a variety of ways. First, it provides the needed capital and state-of-the-art technology that enhances economic growth in the receiver country (Caves, 1996; Dunning, 1993; Blomstrom and Sjöholm, 1998; Smarzynska, 2002; Akinkugbe, 2005).

Second, it augments the skills of the host nation and thus stimulates growth through the infusion of managerial and labour skills and training (de Mello, 1999). Third, it promotes technological upgrading, regarding start-up, marketing, and licensing arrangements (de Mello and Sinclair, 1995; Markusen and Venables, 1999). FDI is thus seen as a catalyst to the host nation's economic growth and development as it enhances technological progress and promotes industrial development concomitantly (Asheghian, 2004).

In addition, FDI can be expected to encourage the economic growth of the host nation, given the prevailing view that MNEs can complement the local industry and stimulate growth and welfare in the host nations (Grossman and Helpman, 1991; Barro and Sala-i-Martin, 1995).

The major determinants of the host country's economic development and growth is the economic environment portrayed by its rate of economic growth, trade policy, political stability, legislation, domestic market size, and balance of payment constraints (Caves, 1996; de Mello, 1999; Dunning, 1993) - *the political economy of*

*the nation*. These factors may inevitably influence the decision of foreign investors (MNEs) on the possible choice of a viable investment location (Akinkugbe, 2005).

### **1.3 A brief conceptual overview of FDI and relevant terminology**

The International Monetary Fund (IMF, 1993:86) defines a direct investment as “the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another economy.” The Fund reiterates that the resident entity is the direct investor, while the enterprise is the direct investment enterprise.

According to the Organisation for Economic Co-operation and Development (OECD, 1996:7), foreign direct investment (FDI) “reflects the objective of obtaining a lasting interest by a resident entity in one economy (“direct investor”) in an entity resident in an economy other than that of the investor (“direct investment enterprise”).” The organisation goes further to explain that the lasting interest signifies the existence of a long-term business relationship between the investor and the enterprise, and a controlling stake by the investor in the investment.

The United Nations Conference on Trade and Development (UNCTAD, 1999:4) defines FDI as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity (the foreign direct investor or parent enterprise) of one country in an enterprise (foreign affiliate) resident in a country other than that of the foreign direct investor.

The IMF (*ibid*) identified the capital contents of FDI as the equity capital, reinvested earnings and other capital. These forms of capital are discussed in detail below:

1. Equity capital- this is the currency value of a foreign investor’s offshore investment in capital shares of an enterprise. An equity capital stake of 10 per cent or more of

the ordinary shares or voting power in an incorporated business (or its equivalent in an unincorporated business) venture is normally considered a springboard to exercise control over the assets of the enterprise, as demonstrated by Barclays Bank of England in ABSA stake (South Africa). This form includes both mergers and acquisitions (M&A), and 'greenfield' investments.

2. Reinvested Earnings- these are the retained profit shares of MNEs that are not shared or distributed as dividends at the end of the accounting period. This form of investment is geared towards increasing the capitalisation position of the enterprise. This in turn increases the stake of the MNEs in the foreign affiliation. This may represent up to 60 per cent of the total outward FDI from countries like the United States and the United Kingdom (Li Hai-Qing, 2001).

3. Other direct investment capital (or intercompany debt transactions) - this refers to the short and long-term borrowing and lending of funds (including debt securities and suppliers' credits) between direct investors and their foreign affiliates, branches, and associates.

The IMF definition of FDI as capital is considered appropriate for the purpose of easy statistical analysis, as it indicates in clear terms the monetary value of foreign capital that a foreign enterprise or an individual intends or actually brings into a country for a long period of time entirely for the purpose of business interests (IMF, 1993).

From the foregoing authoritative definitions, the researcher defines FDI as assets that are controlled and managed by an individual, a group of people or a foreign enterprise (incorporated or unincorporated) in a country other than that of its origin for a long-term business interest.

According to Li Hai-Qing (2001), assets can be categorised as follows: fixed assets, current assets, and intangible assets. He observes that fixed assets are those with long-term investment values, but which depreciates as time passes by. They include land and buildings, furniture and fittings, machinery and tools, amongst others.

Li Hai-Qing (ibid) also sees current assets as convertibles that are consumed in the operational process. They are recycling assets and thus change form in the course of business operations. They include cash in hand and cash in bank, accounts receivables, work-in-progress, materials and inventories that are convertible into cash within the accounting period. Intangible assets are composed of the 'image' built and enjoyed by the enterprise over its long-term operation. They include royalties, goodwill and patents to name just a few.

To qualify as a FDI, "a foreign enterprise or an individual investor would have to bring into the host country some assets for a long-term business operation, which could be a production facility, a trading entity, or a service presence" (Li Hai-Qing, 2001:4). Portfolio investment takes the form of equity securities and debt securities (bonds and notes), money market instruments, and financial derivatives like options (IMF, 1993).

For the purpose of this research, Multinational Corporations/Enterprises (*or transnational corporations*) are defined as incorporated or unincorporated enterprises comprising parent enterprises and foreign affiliates (UNCTAD, 2008:1). A parent enterprise is an enterprise that controls assets used in international production, merchandise trade, or service trade. A foreign affiliate is an incorporated or unincorporated enterprise in a (host) country in which an enterprise resident in another (home) country has a stake that permits a lasting interest in the management of that enterprise (Ibid).

#### **1.4 Why FDI is preferred**

All things being equal, an enterprise would preferably choose to locate its full production facilities in the home country and export its products to foreign markets to forestall risks that are associated with foreign operations (Hough and Neuland, 2007). A concentrated production process at the home nation could breed greater managerial efficiency. This is achieved as the enterprise exercises tight control over its employees and thus develops an efficient and effective organisation culture (Dunning, 1998).

Large-scale production, which is made possible through global exportation, could also help to develop global icon brands (Du Plessis, Jooste and Strydom, 2005). This advances lower costs of production, brand loyalty, and value chain capability through the learning curve and the experience curve, among other scale economies that accrue from mass production/marketing activities (Meyer, 2004).

Alternatively, an enterprise could license the right to produce/market its products to a foreign organisation through a strategic alliance. For example, Aspen Phamacare Holdings Ltd in RSA & GlaxoSmithKline (GSK) entered into a strategic marketing agreement in 2000. Franchising is also a licensing option whereby the home enterprise (licensor) permits the foreign organisation (licensee) to use its brand name/trademark in return for royalties (KFC and McDonald's are global leaders in this strategy) (Pearce and Robinson, 2007).

Licensing appears attractive, but its shortcomings like divulging competency secrets, as experienced by RCA in Japan, loss of control over the foreign subsidiary as in the case of Starbucks in its early days in Thailand or regulatory problems as experienced by Ameritech Corp. in China, all work against realising its full potential. These

identified drawbacks could render licensing as a method of penetrating foreign markets, inappropriate and disadvantageous (Pearce and Robinson, 2007).

In reality, the foreign competitive strategy of any enterprise depends on the political economy of the foreign market, as well as the competitive climate of the marketing environment that confronts the company abroad (Akinkugbe, 2005). The political, economic, legal, and social policies of the government of the foreign market may discourage exportation by raising import duties and tariffs (Steers and Nardon, 2006).

This could also arise if the volumes of certain products that are allowed to enter the country are restricted through import quotas and voluntary export restraints (US restricted the volume of imported Japanese cars between 1981 and 1985). These barriers increase the costs of exports and thus decrease profit margins (Hough and Neuland, 2007).

In order to resolve a series of problems associated with licensing and direct exportation, enterprises may decide to embrace foreign direct investment. Toyota demonstrated the justification for this shift in strategy in the United States, among other prominent global examples. The strategic intent of adopting FDI is to integrate fully into the foreign environment thereby reducing the negative perception of '*foreign*', which makes investment abroad difficult and sometimes unprofitable (Rivera-Batiz and Oliva, 2003).

### **1.5 Problem formulation**

The importance of FDI in international business and, specifically, in the global business environment is crucial. Aided by FDI transactions, the world merchandise trade expanded at a rapid pace during 2006. During this period, growth of the volume of world exports is estimated to have risen above 10 per cent, from the previous level

of 7.4 per cent in 2005, while the value of the world exports increased by 16 per cent (UN, 2007:35).

The fact that the growth of world exports is more than double that of the world output; indicates a further intensification of global integration (UN, 2007). Hill (2007:239) endorses this viewpoint when he observes,

...as a result of the strong FDI flow, by 2003 the global stock of FDI exceeded \$8.1 trillion. At least 61,000 parent companies had 900,000 affiliates in foreign markets that collectively employed some 54 million people and generated value accounting for about one-tenth of global GDP... (*and*) an estimated \$17.6 trillion in global sales, nearly twice as high as the value of global exports which stood at \$9.2 trillion.

The impact of this achievement on the global standard of living has been momentous. It was observed (Versi, 2003:10) that this increase in both the stocks and flow of FDI has been credited with creating unsurpassed prosperity across the globe, albeit in varying degrees. According to Versi (*ibid*), FDI “has contributed largely, some say, exclusively, to the very rapid rise in incomes in those (*advanced*) countries.”

The significance of FDI in all economies makes it almost impossible for any nation state to ignore active participation in attracting as much FDI as possible. Versi (*ibid*) went on to state that, “...while developed countries look to FDI to maintain and increase growth, the developing world sees FDI as a means to catapult themselves out of poverty.”

Given the crucial roles played by FDI in the growth and development of economies, the flow of FDI to Africa, one of the continents of the world that most needs its inflow (with a population of about 0.7 billion- World Bank, 2005), has generally been very low. The world record was put at US \$1.2 trillion for 2006 (UN, 2007:65).



In the same year, FDI was quoted at US \$800.7 billion for developed nations - a growth rate of 47.7 per cent, while the same report shows US \$367.7 billion for the developing nations – a growth rate of 10.0 per cent. Of all these increases, Africa recorded approximately \$38.8 billion for the year. Although, this amounted to a growth rate of 26.5 per cent, it still forms just about 3 per cent of the world total or less than 11 per cent of the portion of developing economies (UN, 2007:65).

### **1.5.1 The main problem**

Despite all efforts by the government to attract inward FDI to South Africa, it appears that very little has been achieved so far. For instance, South Africa was grouped amongst the Low FDI performance countries between 1988 and 1990 (UNCTAD, 2008). This situation has since changed as the country was categorised as a FDI Under-performer in 2005 (UNCTAD, *ibid*). The Global Competitiveness Report for 2007-2008 indicates that out of 131 countries, South Africa now (2008) ranks 46<sup>th</sup> as compared to 40<sup>th</sup> in 2005, on the Global Competitive Index (The Global Competitiveness Report, 2008). This necessitates probing into what South Africa needs to do to enhance its global competitiveness towards attracting more FDI.

This research will focus on a study of the effectiveness of policies that are aimed (directly and indirectly) at attracting and sustaining FDI in South Africa. The approach considered applicable in this regard is an evaluation of the macroeconomic policies of the government, as this points to the policy direction of the economy and the state of the nation's political economy (Hill, 2007).

A favourable political economy does influence a country's attractiveness to inflow FDI (1.2, paragraph 5). One may therefore contend that, all things being equal, the more favourable the political economy of a nation state, the more attractive it is for inflow FDI. Recently, there have been serious efforts by African leaders, and

specifically, South African leaders, to liberalise trade and privatise state assets as a means of embracing foreign investments (Wessel, 2007). But these efforts seem to be inadequate as the stock of FDI (greenfield) still remains very low (UNCTAD, 2007).

## **1.6 Research question**

This research aims to probe why South Africa has not been competitively successful in attracting FDI as demonstrated by other developing (Asian) economies such as Thailand, and Malaysia, with whom South Africa is in the same league (per capita income - in excess of US\$ 3,000, good infrastructure, legislative and legal frameworks) (Hough et al, 2003) despite government's efforts in this direction?

## **1.7 Objectives of the study**

### **1.7.1 The primary objective**

The findings of an earlier research project ('desk study') conducted by the researcher<sup>1</sup> suggests that the ineffectiveness of investment regulatory policies is one of the major hindrances to FDI inflows into South Africa. This research is aimed at evaluating the impact (negative and positive) of these investment related policy frameworks that regulate the investment environment as well as the socio-political and cultural system (the political economy).

It will also find out how these issues rate relative to other developing nations in the minds of foreign investors in South Africa. This will help to understand why foreign investors are unwilling to invest, on a long term basis, in South Africa. Some factors that are also widely adjudged to be important to investment considerations (sections 1.1 and 1.2) will be given attention, under the research sub-objectives, as indicated below:

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<sup>1</sup> A Critical Analysis of South Africa as a Destination for Foreign Direct Investment (FDI), Business Report, UNISA, January, 2006.

### **1.7.2 Sub-objectives (Secondary objectives)**

- (a) To establish the factors considered by foreign investors when choosing investment destinations. This information will be elicited from the research questionnaires that will be administered through the investors' survey.
- (b) To investigate what influenced the current foreign direct investors in South Africa, to choose this country. This information will also be derived from the response(s) of the investors through the administered questionnaires.
- (c) To investigate what problems foreign investors in South Africa are experiencing at present.
- (d) To investigate how South African policy frameworks (that is, the macroeconomic policies) rank in the minds of foreign investors as compared to the currently more attractive destinations for FDI (e.g. India and China).
- (e) To investigate the influence of bilateral agreements/ties that exist between South Africa and other countries on the investors and how these agreements/ties influence inflow foreign direct investment into South Africa.

### **1.8 Research Hypotheses**

The research hypotheses are designed to reflect the significance of investment related policy frameworks, and or other issues/forces, as they influence the attractiveness of South Africa as a destination for FDI. The main (null) hypothesis ( $H_0$ ) is designed to establish the assumption that policy frameworks do not potentially improve the attractiveness of South Africa to inflow FDI (if this assumption holds, the main hypothesis 'H<sub>0</sub>' is not rejected.), while the alternative hypothesis ( $H_{a1}$ ) is designed to negate the main hypothesis by validating that policy frameworks do improve South Africa's attractiveness to inflow FDI. The same principle applies to the second hypothesis ( $H_{02}$ ), which evaluates the impacts of 'other variables' on South Africa's attractiveness to inflow FDI.

## Hypothesis 1

H<sub>01</sub>: Investment related policy frameworks (mainly the macroeconomic policies) **do not improve** the attractiveness of South Africa to inflow FDI.

H<sub>a1</sub>: Investment related policy frameworks (mainly the macroeconomic policies) **improve** the attractiveness of South Africa to inflow FDI.

## Hypothesis 2

H<sub>02</sub>: Investment related policies **are not** the only variables that **hinder** the attractiveness of South Africa to inflow FDI

H<sub>a2</sub>: **Only** Investment related policies **hinder** the attractiveness of South Africa to inflow FDI.

## 1.9 Scope/limitations of the study

The study is designed to investigate the effects of the political economy of South Africa on attracting FDI, with special reference to the policy frameworks that influence the attractiveness of the country as an investment environment. To achieve this, the main focus of this research will be on evaluating the effectiveness of South Africa's macroeconomic policies as they relate to achieving an investor-friendly environment.

This research will not investigate other factors, forces, and/or issue that does not relate directly to investment policies in South Africa; for example, environmental differences of climate and geographical location of the country. Although, they contribute to the attractiveness of an investment location, they do not form a part of the scope of this research.

### **1.10 A sample of the population**

Due to time constraints, finance, and other related logistics that may hinder considering the entire population size, the research will be confined to a randomly selected study population, which will allow generalisation in respect of the entire population. Further details of the selection technique will be indicated in the chapter that deals with research methodology.

### **1.11 Motivation for the study**

Arising from concerns over the state of economic development in Africa, and especially, South Africa, it was decided by the researcher to probe the reasons why inflow foreign direct investment (FDI), which is generally regarded as the catalyst for economic development (Versi, 2003) is still subtle to the African continent and specifically, South Africa (Hough et al, 2003).

Previous findings by the researcher<sup>2</sup> suggests that the ineffective investment related policy framework *appears* to be one of the major weaknesses in attracting inflow FDI to South Africa, as these foreign investors are highly sensitive to regulatory principles and location specific advantages (Asheghian, 2004).

To validate the finding of the 'desk study,' this research will focus on a critical empirical analysis of the investment regulating policy framework to interrogate the factors that militate against attracting FDI to South Africa as compared to other developing Asian countries (such as China, India, Malaysia and Thailand). In addition, the study will evaluate what needs to be done in reality to convince foreign investors, possibly through policy reforms, of the willingness of South Africa to compete with

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<sup>2</sup> Honours Degree Business Report entitled: A Critical Analysis of South Africa as a Destination for Foreign Direct Investment (FDI).

other nations in the global share of FDI, in order to increase the amount of its inflow to South Africa.

### **1.12 Research methodology**

This research will be conducted using primary and secondary sources of data. The primary data will be generated through information that will be elicited from the field survey (the questionnaires).

Two in-depth questionnaires will be designed; one for each of the survey groups namely the foreign investors and appropriate government institutions and organs (the policy makers), to collect the primary data. The questionnaires will contain Likert scale, open-ended and scale questions, and will be structured in a way to cover the objectives of the proposed study in detail in order to help test the research hypotheses.

The completed questionnaires will be checked for validity and reliability. The necessary computer software applications will be used to analyse the generated responses. Frequency tables will be used, along with cross tabulation. Pearson's Exact significance tests will be conducted to establish the relationship between the independent variable (macroeconomic policies of South African government) and the dependent variable (the responsiveness of FDI to policy measures).

The literature review will be based on secondary information generated from information bureaus such as Statistics South Africa, the Department of Trade and Industry (DTI), and through a review of relevant publications like books, academic journal articles, the Internet and other academic sources. The literature review will lay a foundation for knowledge that will be useful in evaluating the validity of the formulated hypotheses against the statistical outcome of the analysed data.

### **1.12.1 Research assumptions**

The following assumptions guide the understanding of the procedures to be followed in conducting the research exercise:

- (1) That the researcher does not have control over the response pattern of any of the respondents. In addition, the respondents are free to respond to the questions objectively, and that their responses will be treated with the utmost confidentiality.
- (2) That the researcher has no control over the person (respondent) who actually completes the questionnaires. It is assumed that the person, to whom the questionnaire is addressed, will ultimately complete it.
- (3) That there is a relationship between South Africa's macroeconomic policy framework and the attractiveness of the country to inflow FDI.
- (4) That there is no relationship between South Africa being a developing nation and its attractiveness as a destination for FDI, given that other developing nations in Asia and South America (such as India, China, Malaysia, Thailand, Brazil, and Mexico, to mention but a few) are attractive to inflow FDI.
- (5) It is hoped that the deficiencies (if any), discovered in the investment related policy frameworks, if improved upon, may lead to an increase in the inflow of FDI to South Africa.

#### **The questionnaires:**

##### **(1) Investors' survey**

The researcher developed a survey questionnaire that was completed by investors (Foreign Direct Investors) to test the abovementioned hypotheses.

A sample survey of the Foreign Direct Investors was obtained, along with their contact details from the Department of Trade and Industry (DTI), Business Monitor International, and other relevant databases. The questionnaires were mailed to the identified investors after obtaining their willingness to participate in the research. Investors were asked to rank, evaluate, and compare the various dimensions and considerations of national investment policies (especially, the macroeconomic policies) in order to establish the viability of South Africa as a favourable destination for FDI, from the investors' perspective.

The identified deficiencies in government policies (as identified by investors) were compared to the views expressed by the other stakeholders considered in the research.

A comparison between different investors on the dimensions and sectoral characteristics of investment was conducted, in order to interrogate if any particular investment/sector enjoy(s) any distinct advantage in terms of policy and incentives, over others. Untapped opportunities of investment may be revealed in some industries through the investors' responses.

## **ii The policy makers' survey**

The researcher also developed a survey questionnaire that was completed by relevant officers of the Department of Trade and Industry (DTI), Provincial Members of Executive Committee (MECs) in charge of investments, and other related government organs, to test the above-mentioned hypotheses.

The most senior officials of the various units in the departments/organs were approached to provide the names and contacts of the relevant persons that would be most suitable to complete the questionnaires. Pursuant to a preliminary arrangement,



the volunteers were handed the questionnaires for completion. A date was agreed upon for the collection of the completed questionnaires.

Respondents were asked to rank, evaluate, and compare the various dimensions and considerations of national investment policies in order to establish the viability of South Africa as a favourable destination for FDI, from the perspective of the policy makers. This information was compared to the views, opinions, and considerations of the investors and relevant literature.

A comparison between different officials on the dimensions and sectoral characteristics of investment policies, operations and practices was conducted, in order to determine whether the investment policy plans differ from reality, and how this policy system ranks compared to other developing nations (identified in 1.11, third paragraph).

### **1.13 Plan of the dissertation**

The dissertation is structured as stated below:

#### **Chapter one - Introduction and background to the study**

This chapter will contain the following:

- Introduction and background to the study
- Preliminary literature survey
- A brief conceptual overview of FDI and relevant terminology
- Why FDI is preferred
- The problem formulation
- The research objectives
- Research hypotheses

- The research methodology
- The scope/limitations of the study
- Motivation for the study

## **Chapter two - The theoretical framework, practice, and contents of FDI: a general overview**

This chapter will mainly deal with discussions on the theoretical framework, practice, and contents of FDI. It will be structured in a way to reflect dynamism in the advent, organisation, and growth of trade, globalisation, and FDI. It will analytically cover the following:

- The theoretical framework of trade, globalisation, and FDI
- The general content of FDI and the determinants of its direction
- Foreign investments and the role of MNEs
- The impacts of MNEs (FDI) on national economies

## **Chapter three - The theoretical framework, practice, and contents of FDI with special reference to South Africa**

This chapter will look at the general contents of FDI in South Africa. It will be arranged in a way to reflect the trend of inflows since 1994 (post democratic era) till 2006. This is intended to reflect the effectiveness of policy-change over the period under consideration, in attracting FDI. The chapter will cover (among others) the following:

- The trends in inflow FDI to Southern Africa since 1994 till 2000
- The content of FDI in South Africa

- The linkages between the three sectors of the economy - primary, secondary, and tertiary
- Presence of some MNEs in certain sectors of the South Africa's economy:

#### **Chapter four – The dynamics of trade and investment environment in South Africa from the pre-colonial era till 1993**

This chapter will look at the following in some detail:

- The pre-colonial investment era
- The colonial/apartheid investment policies and practices
- The policy focus (macroeconomic policy stance) during the transition to democratic rule

#### **Chapter five – Trade and investment related policies and practices in South Africa from 1993 till 2006**

This chapter will deal in some detail with the following:

- The macroeconomic policy of the Government of National Unity (GNU)
- Policy frameworks like the RDP, the GEAR and more recently, the ASGISA
- Lessons learnt from these policy frameworks and their effectiveness in creating an investor-friendly environment

#### **Chapter six - Research Methodology**

This chapter will deal with the following:

- Population and sampling
- Design of questionnaires
- Survey groups

- Collection of Data
- Analysis of the data

### **Chapter seven - The findings**

This chapter will consider the following:

- Interpretation of various analyses
- The effectiveness of South Africa's macroeconomic policies in creating an investor-friendly environment. The competitiveness of South Africa's investment related policies.
- The effects of other variables like crime, market size, labour regulations and so on, as they impact on inflow FDI to South Africa.
- The possible policy intervention/reform capable of addressing inequalities in South Africa.

### **Chapter eight - Summary of findings, recommendations and conclusions**

As the concluding chapter, it will discuss the findings of the research and recommend possible appropriate solutions for the identified problems.

## **CHAPTER TWO**

### **THE GENERAL OVERVIEW OF THE THEORETICAL FRAMEWORK, PRACTICE, AND CONTENTS OF FDI**

#### **2.1. Introduction**

This chapter will deal with a relevant discussion of the theory and practice of FDI, with special reference to South Africa. It views the evolution of globalisation briefly, and it looks at the advent and dynamics of FDI, and the factors that facilitate its flow and direction. The chapter will also consider some of the motivations as countries nowadays strive to attract as much FDI as possible; keeping in mind FDI's contribution to the growth and development of economies.

In addition, the factors that make a location more favourable for investment than others will be considered. The contribution of world agencies and institutions like GATT (now the WTO), the IMF, the World Bank and the UNCTAD to name only a few, to modern global economic integration will also be examined.

#### **2.2 Globalisation and FDI**

The following discourse is aimed at tracing the progression of globalisation and foreign direct investment. It will go further to discuss some relevant conceptual frameworks of FDI as they apply to Africa in general, and South Africa in particular.

Trade and investments have a historical basis. Recent efforts by individuals and nation states to participate in trade may have been influenced by the trade practices of many centuries ago. In the early days of trade, it was discovered that people's participation in any kind of trade (national and international trade) was an unquestioned necessity as it augmented (and still augments) economic growth and development (Ball and McCulloch, 1988).

Opportunities provided by trade through the exchange of goods and services, which includes the availability of a variety of merchandises and the proceeds on sold items, earns an increased per capita GDP for participating countries (ibid). This invariably improves both the living standards and the quality of lives of the people. Given the impact of trade on the nation and individuals, it is not surprising to observe the serious efforts of all the stakeholders at maximising its efficiency as a way of realising its full potential (Versi, 2003).

### **2.3 The early practice of trade**

In general terms, trade and trade-related activities are as old as the history of humankind. Ball and McCulloch (1988) support the notion of the early advent of trade as they observe that, even before the time of Christ, merchants were sending representatives abroad to sell their goods. The idea of exchanging goods for goods or services for services (trade by barter) arose because of the inevitability of *exchange* in the olden days. According to economic theories, no person or nation could satisfy its ravenous needs and desires satisfactorily and economically only by means of its local production/resources (Root, 1994; Ghauri & Buckley, 2002).

The contributions of trade and investment to communal settlement were momentous. Czinkota, Muffett and Ronkainen (1994:4) observe, “Ever since international borders were formed, international business has been conducted by nations and individuals. In many instances, international business itself has been a major force in shaping borders and changing world history.” The authors draw deduction on the more recent global trade records from the historical economic achievement of old trading regimes like the then Roman Empire, which was widely praised by literature for its unequal economic feat.

The practice of international trade in the early periods of civilisation was not carried on free of charge, a practice that is still relevant today. The duties, royalties, tariff, and taxes that are applied in modern economies do not only apply to modern policies but rather, they have evolved as integral to trade phenomena. For example, in the old Roman Empire, city nations, and tribes outside the Empire agreed to pay tributes and taxes for the benefits that accrued from the trade relationships, which by far surpassed the drawbacks inherent in the symbiotic trade system (Czinkota et al, 1994).

## **2.4 General historical perspective of FDI**

The growth and development recorded by modern investment systems could arguably, be credited to a very significant level, to foreign direct investment. The practice and conduct of FDI can be traced back to the 1600s when the British East India Company was identified as the first enterprise to invest abroad (Ball and McCulloch, 1988). The authors point out that this venture was soon emulated by the American plants set up by Colt Firearms and Ford (vulcanised rubber) in the 1700s.

Despite early entry into foreign investments, American enterprises did not record successful operations abroad until 1868, when the Scottish production facility of Singer Sewing Machines ventured abroad. Singer Sewing Machines recorded rapid profitability and growth because of its overseas operations during the period, as a result of its improved production efficiency and location specific advantages (e.g. low labour costs and favourable foreign investment policies).

The success recorded by Singer Sewing Machines motivated other organisations and investors to adopt FDI as an appropriate foreign expansion strategy as it was considered to be a lucrative business move. This led to a rapid increase in the number of foreign investment because by 1914, about 37 American enterprises had established

two or more foreign operations to enjoy similar foreign sales, organisational efficiency, and high-standard production techniques similar to that recorded by Singer Sewing Machines abroad (Ball and McCulloch, *ibid*).

Ball and McCulloch quoted the Organisation for Economic Cooperation and Development (OECD), who observed the 'explosive growth' in both the size and number of the U.S. and other foreign multinational companies' that were involved in FDI between the 1970s and 1980s. The global value of investments was quoted at about \$650 billion, more than six times the value of \$105 billion for 1967. In recent times, the figures have risen to a very high level. They rose from US\$710.8 billion in 2004 to US\$ 1.2 trillion in 2006 (UN, 2007:64).

According to Versi (2003), a rapid increase like the one mentioned in the previous paragraph, indisputably bolsters the argument in support of the sustained growth of global investments, and its corresponding effects on the people of a country. This growth and efforts to sustain it, is due to the fact that many countries have benefited significantly from foreign investments in the form of increased level of prosperity.

The following paragraph will interrogate the arguments in support of the contribution of investment to increasing human prosperity or at best, increasing the standard of living of the people.

## **2.5 Impact of investment on the people**

The importance of investment towards raising the standard of living of the people will be examined through a historical perspective. This discourse will relate to the more recent developments. The argument of Krause (1965) in this regard is considered appropriate, as he identified two closely related scenarios that illustrate



how investment helps to raise the standard of living of people. His argument is presented below:

### **2.5.1 Factor endowment:**

The first explanation given by Krause is that not every country is equally endowed with the capacity to produce all products and services. This point is understood to have supported the theory of absolute advantage as propounded by Adam Smith. Some authors (Markusen, Melvin, Kaempfer and Maskus, 1995; Hough and Neuland, 2007) observe that a country has an absolute advantage regarding certain products if one unit of labour produces more of it than is produced by one unit of labour in another country.

This could imply that since some factor inputs are more concentrated in certain locations than others, it would be economically expedient to locate the production facility that makes use of those input materials in that area. This process gives that country an absolute advantage of such factor inputs over others; and subsequently, an absolute advantage regarding production of the related products.

Logically, this theory explains investors' motivation for locating most of the energy generating and processing organisations in Africa and the Middle East where crude oil reserves are in abundance. It also makes sense for SASSOL to be located close to its source of coal- the main input material.

### **2.5.2 Location specific advantages:**

The second point Krause makes centres on the environmental differences of climate, labour supply, and culture. This can be linked to Ricardo's theory of comparative

advantage. In this regard, Krause argues that international trade/investment occurs largely because of international differences in the costs of factor inputs.

According to Ricardo, the theory of comparative advantage promotes the principle of location cost advantage. The explanation is based on the logic that it does make sense for a country to specialise in the production of those goods that it has the capacity to produce most efficiently and to buy those goods that it produces less efficiently from other countries that have a comparative advantage in producing such goods. The simple equation here is that the autarky price (the market price of the final product) of the comparatively advantaged country will be smaller than the comparatively disadvantaged country's autarky price (Rivera-Batiz and Oliva, 2003).

The position of Krause was that the main reason for investing abroad is to reduce costs associated with production, distribution and marketing of goods and services. This coupled with Ricardo's theory of comparative advantage suggest that locating production facilities at the least cost sites would improve the standard of living of the people who would have the advantage of buying higher quality products at lower prices (Asheghian, 2004).

Salil (1995:28) also shares the same opinion when he observes,

When nations concentrate their production on commodities in which they have a comparative advantage, consumers as a whole benefit from lower prices and a greater range of consumption possibilities. Because each product is produced by the country that is best at producing it, scarce world resources are allocated efficiently.

For goods and services to be produced at production sites that offer the best-cost advantages, some measures must be put in place to allow the free movement of factor inputs and distribution of finished products/services. The GATT and its successor, the WTO, have facilitated this process.

## **2.6 GATT and WTO in the global investment**

The challenges facing world leaders are to ensure reasonable degrees of open economy and trade liberalisation, a process that enhances the free location of production facilities at the most favourable locations for investors. This has resulted in the establishment of a global structure charged with the responsibility of erecting a new economic world order aimed at fostering greater trade integration and liberalisation.

To actualise these strategic objectives, a group of visionary world leaders (representing 44 countries) converged in Bretton Woods, New Hampshire (United States) in 1947 to establish the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), and the World Bank. Based in Geneva, GATT pooled more than 128 member nations from the pioneering membership of just 19; and many more countries were eager to become members before its transformation (Elmawazini et al, 2005)

The influence of the GATT on world trade/investment was tremendous. Over the past few decades, GATT has established the framework for conducting and practising trade. A system of free creation and distribution of value-added activities and services has been enhanced by the body, which in various capacities, has acted as a conduit for realising a free trade regime, a system that facilitates FDI (Anderson, 2005).

Today, most economists acknowledge this trading system as one of the greatest contributors to the world's rapid economic recovery from the desolation of the Second World War, and to the phenomenal growth in the world output thereafter (Salil, 1995)

Although the contributions of GATT to global investment prosperity was immense, the desire of world leaders to rectify the inherent deficiencies in its statutory capability to enforce decisions, led to the Uruguay Round accord where the GATT's successor, the World Trade Organisation (WTO) was officially announced.

The inherent shortcomings in the formation and administrative processes of the GATT rendered the organisation a mere negotiation medium with absolutely no statutory enforcement mandate. In short, it was just another table where issues were discussed and resolved through consensus that was not statutorily binding.

The challenges facing economic globalisation and world trade systems necessitated a better structured, well informed and powerful (in all international dimensions), successor to GATT and hence the birth of the World Trade Organisation (WTO).

## **2.7 Contribution of the WTO to the growth of global investment**

The formation of the WTO in 1994 (it became effective on 1 January, 1995) has helped to lower trade barriers and non-tariff barriers (NTBs) in hitherto restricted trade sectors like textiles and apparel, agriculture, services and intellectual property - all of which constitute rapidly emerging sectors for viable international investment. With its current 148 members and another 25 more waiting to become members, it has always remained in the forefront of promoting global free trade with a statutory mandate to enforce related rules (WTO, 2008).

Under the WTO, member nations are no longer able to block adoption of arbitration reports on any trade disputes. Although article two of the UN General Assembly's Charter that allowed members states autonomy to choose and respond to FDI based on the individual's circumstances, is retained in the WTO provisions (Narula and Lall, 2006).

The WTO is a strong regulatory body with the power and authority to formulate, implement, enforce, and mediate in all forms of trade related matters. In fact, the organisation serves as the mainstream of free trade and economic globalisation. Opponents of the WTO have argued in the recent past that the organisation is too powerful because it can declare the laws and regulations of sovereign nations in violation of global trade rules void, in effect pressuring nations to either relax or repeal these laws.

The WTO played a crucial role in facilitating global free trade and the liberalisation of state economies in globalisation of both goods and services. Consequently, FDI flows responded positively almost immediately as shown by investments in both areas. By 2004, trade in service amounted to some US \$2,100 billion compared to world trade in goods, that was quoted at \$8,800 billion for the same year (WTO, 2005)

Hill, (2007) states that the communication deals brokered by the WTO in 1997 paved way for the 'complete' liberalisation of the industry across the globe, most especially, in most of the world's biggest markets like the United States, Japan and the European Union. According to the same author, in December of the same year, the deal was extended to the financial sector and it covers more than 95 per cent of the world's financial services market.

This accord was acceded to by all member countries but more interestingly, by the world's biggest markets; with little modification. The European Unions and the United States open-up their markets fully to foreign banks, insurance, and securities enterprises. This agreement has helped to facilitate a rapid increase in the global flow and stock of the FDI in the financial services and other related sectors. The investment of Barclays Bank of England in the ABSA Bank of South Africa would not have been possible without a facilitating vehicle of this nature.

The effect of these investment accords has not only influenced the service sector but has also had noticeable effects on other sectors as well. The average yearly outflow of FDI increased from about US \$25 billion in 1975 to a record US \$1.2 trillion in 2000, before falling back slightly to an estimated \$620 billion in 2004 (UNCTAD, 2005). Over this period, the flow of FDI accelerated faster than the growth in world trade and world output. Between 1992 and 2004, the total flow of FDI from all countries increased by about 260 per cent. By 2003, the global stock of FDI exceeded US \$8.1 trillion (Hill, 2007).

The flow and stock of global FDI in recent times is in keeping with a rapid increase in the volume and stock of global trade. Even though, there was a general recess in the flow and stock of the FDI in 2002, records show a significant improvement in the distribution of global investment.

According to UNCTAD (2006), the FDI worldwide increased in 2005 by about 29 per cent from the previous year. The organisation further observes that increases recorded in global FDI stock was significant for both developed and developing nations alike. According to the report, inflow FDI was quoted at US \$896.7 billion in 2005 for developed nations, an improvement of 38 per cent; in the same year, inflow was US \$273.5 billion for the developing nations, an increase of 13 per cent. Africa as a whole recorded just about US \$29 billion for the year.

Although, this share of Africa does not look impressive when compared to the global stock, the importance of this slight improvement is significant for the GDP of the continent. The United Nations Industrial Development Organisation (UNIDO 2005:2), quoting Crook 2003, indicates that a recent survey of global finance published in 'The Economist' presents a review which states that by 2000 the GDP of

developing nations had gained about US\$ 350 billion a year (roughly five per cent in goods and services) as a result of their access to international markets including FDI.

The research further declares that a rise of one per cent point in the ratio of the stock of FDI to GDP will raise the GDP by 0.4 per cent. To give a practical example “in the decade to 2000, the ratio of FDI to GDP in the developing countries went up from seven per cent to 21.2 per cent. That rise of 14 per cent points implies an improvement in GDP of 5.6 per cent.”

This analysis reveals that although, the effect of FDI on the African GDP was small, it, was still significant. It has further been observed (UNCTAD, 2006) that the impact of FDI stock on the Gross Fixed Capital Formation (GFCF) and the GDP in Africa is higher than on any other continent of the World.

## **2.8 The conceptual overview of globalisation**

Many researchers and institutions (UNCTAD, 2001; Johnson & Turner, 2004, Havila, Forsgren and Hakansson, 2002) see globalisation as a connecting rod between trade and foreign direct investment. The theoretical framework and practical applications of FDI ideology and principles have helped to proffer solutions to the problems emanating from state-inclined protectionism and other related impediments previously encountered by foreign investment.

This progression helps one to realise the benefits associated with trade liberalisation and free market economies. As an instrument of globalisation, FDI has helped to recondition the new world order regarding investment. The impact of world institutions and agencies on promoting globalisation and its instruments - FDI, and capital movement (portfolio investment), have been significant.

The foundation laid down by GATT and perfected by its successor, the WTO in the areas of trade liberalisation and market openness have aided anti-protectionism (Zander, 2002). These organs are believed to have facilitated globalisation recently, which in itself is understood to have contributed to the recent development and growth in the world economy.

Globalisation can be viewed from a wide range of perspectives. This term covers a wide spectrum of issues and activities involving different geographical locations of the world and how these regions have managed to converge into a 'small village' despite their significant disparities. As such, a well-embodied definition will be required to cover this extensive concept. A good point of departure will firstly, be the World Bank's definition of globalisation that is seen as the global integration of economies and societies (World Bank, 2002). In this sense, globalisation is viewed as a process that connects the entire world irrespective of geographic divide.

Zander (2002:160) again defines globalisation as "the further expansion of the economic and symbolic architecture of modernity." Here, the author observes that national borders are fast becoming seamless as economies and cultures become increasingly interwoven. Although, this definition describes a steady movement in the process of adapting to a modern system, life-style, and worldview, a more expansionary definition may be required to do adequate justice to this complex concept.

The definition by Johnson and Turner (2004:4) is therefore, considered wide enough for the purpose of this research. Quoting the IMF's World Economic Outlook, these authors define globalisation as 'the growing interdependence of countries worldwide through the increasing volume and variety of cross-border transactions in goods and



services and of international capital flows, and also through the more rapid and widespread diffusion of technology.’

According to this last definition, the authors see globalisation as a by-product of an increase in:

- International trade in both goods and services;
- Increase in international capital flow, and
- Increase in technological advancement and its widespread diffusion.

This definition also highlights the fact that globalisation covers every instrument of investment/trade and their practical applications. With the easy flow of goods and services, the proficient allocation of relatively scarce global resources is achievable. Consequently, this process allows global manufacturers to seek and exploit location specific advantages across the globe (Salil, 1995).

Accordingly, the standard of living of the people is raised as it offers good quality products at lower prices. In addition, the profit motives of the MNEs are fulfilled - thereby creating more investible capital (Ghauri and Buckley, 2002). In addition, the rapid increase in technological innovation and diffusion has helped to blur global national differences regarding the dimensions of place and time.

Because of the latest technology, the international financial market never sleeps. This is responsible for the continuous dissemination of useful investment information and the fact that investors are better equipped to follow financial trends and make informed decisions. This may be regarded as the basis of global financial volatility (Magubane, 2004). MNEs also maximise the use of information technology to ensure the fast diffusion of information, which results in increasing the global quality of life and welfare of societies (Havila et al, 2002).

Two components of globalisation have been identified, namely the globalisation of markets and the globalisation of production (Hough et al, 2003:34). They are explained in more detail below:

### **2.8.1 Globalisation of markets**

This is a process that ensures the amalgamation of historically distinctive and sharply divided world markets into one global marketplace. This principle signifies that manufacturers/investing organisations are free (to some extent) to sell their products to individuals, communities, nation states, or regions of the world without any perceptible impediment.

### **2.8.2 Globalisation of production**

This increases the investors' freedom to locate manufacturing facilities in any community, nation state, or region of the world without any evident restrictions. In Hill's (2007) opinion, the globalisation of production is the sourcing of goods and services from locations around the globe to take advantage of national differences in costs and the quality of factors of production such as labour, land, energy, and capital. This list may also include high weight-to-value natural deposits, as this forms the basis of major FDIs specifically in Africa.

## **2.9 The theoretical framework of FDI**

Many entry modes are open to MNEs as part of the strategies of expanding their operations abroad. MNEs could choose to export their manufactured goods from the parent country to foreign markets, the licensing of goodwill and brands are also possible, and franchising (a type of licensing) also appears to be a good option. Other possible options are management contracting, turnkey projects which could also be

profitable, joint ventures that have always proven to be good options, and FDI too, has been very popular with investors (Stiglitz and Charlton, 2005).

MNEs venture abroad by choosing the most appropriate international marketing strategies that suits their corporate strategic intent the best. International organisations adopt foreign market penetration strategies conforming to the existing organisational architecture with the aim of establishing synergy, and to bring about the leverage of operational resources (Pearce and Robinson, 2007). In this way, MNEs generally begin international expansion through exporting.

Products are manufactured in the home country for exportation and are subsequently distributed to targeted foreign markets. In fact, this strategy was popular among MNEs in their early periods of foreign expansion (Hough and Newland, 2007). Toyota applied this strategy to the North American market during its early days in the region. Coca Cola and many other international enterprises have adopted this strategy at some points in the course of their global operations. Organisations that began foreign operations involving exporting, were forced in most cases, to rethink their strategies when protectionist pressures from the host countries made operations in such environments difficult and unprofitable.

In the past, restrictive measures from host governments have forced many organisations to be more proactive by adopting a FDI strategy. Although, a closer look at the costs and risks associated with FDI presents a discouraging picture, it is preferred by far to other foreign expansion strategies by investors (Stiglitz and Charlton, 2005). The question that arises is what makes FDI more preferable despite its evident drawbacks.

### **2.9.1 Reasons for choosing FDI**

The costs associated with FDI, as compared to other methods of penetrating foreign markets are extremely high, and the associated risks are enormous. Ideally, an enterprise would preferably choose to locate its full production facilities in the home country and export its products to foreign markets (Du Plessis, et al, 2005). Exporting of products to foreign markets could help minimise the uncertainty and unforeseeable risks associated with foreign operations (Pearce and Robinson, 2007).

Maintaining a single production site could lead to greater managerial efficiency, as the company will be able to exercise tight control over its employees and sustain the enduring working organisation's culture to a large extent. Large-scale production, which is made possible by exportation, could also help to develop global icon brands (Du Plessis, et al, 2005). In addition, this possibility can result in lower production costs and enhance value chain capability as a result of gaining valuable experience, among other resource-based values (Pearce and Robinson, 2007).

Alternatively, an enterprise could grant a license that gives the right to produce/market its products to a foreign company through a strategic alliance (Aspen Phamacare Holdings Ltd in the RSA and GlaxoSmithKline (GSK) entered into strategic marketing agreements in 2000). Franchising is also a licensing option whereby the home enterprise (licensor) authorises a foreign enterprise (licensee) to use its brand name/trademark in return for royalties (McDonald's is renowned for this strategy). A turnkey project (ready-made technology designed for the specific use of a customer) is also a way of selling intellectual property for profit (Hill, 2007).

Licensing appears to be the best option for penetrating foreign markets, but negative experiences in the past have reduced the attractiveness of this option considerably. Negative consequences such as the disclosing of competency secrets, as experienced

by RCA in Japan, the lack of managerial grip on the foreign subsidiary as experienced by Starbucks in its early days in Thailand and regulatory problems as experienced by Ameritech Corp. in China, amongst others, renders licensing as a method of penetrating foreign markets, practically unwise.

In reality, the international strategic competitive choice of any enterprise is determined by the political economy of the target market as well as the competitive nature of the marketing environment that confronts the enterprise abroad (Akinkugbe, 2005).

The political, economic, legal, and social policies of the host country may discourage importation by raising import duties and tariffs. This can also be achieved by restricting the volume of certain products that may enter a country through import quotas and voluntary export restraints. These non-tariff barriers are not unusual in international business. For example, the United States restricted the volume of imported Japanese cars between 1981 and 1985 (Hough and Neuland, 2007). South Africa is currently doing the same regarding the Chinese imported textiles.

These obstructions do increase the costs of exports and thereby decrease profit margins. In order to circumvent the series of problems that are associated with licensing and direct exportation, enterprises rather embrace FDI. Toyota demonstrated the justification for switching over to FDI in USA in the 1980s.

### **2.9.2 Types of FDI**

There are two types of FDI namely horizontal and vertical FDI. Horizontal FDI takes place when an enterprise manufactures the same product in different countries while the Vertical FDI occurs when an enterprise performs different stages of the

production process in different countries thereby generating intra-organisational trade (Rivera-Batiz and Oliva, 2006).

For a detailed analysis of the justification for adopting these strategies, the opinion of Hill (2007:246-252) will be used. The explanations offered by this author will be discussed below:

### **2.9.2.1 Horizontal FDI**

Horizontal FDI occurs when a domestic enterprise invests directly abroad in the same industry in which it operates at home. Wall Mart, Nestle, Cadbury, Carefour, Cemex, SAB Miller, Anglo American, and some other notable MNEs carry out horizontal FDI chiefly as an international strategy to expand the organisation's operational capacity.

As stated earlier in 2.10.1, FDI is always expensive and risky when compared to exporting or licensing. The amount of resources committed to any given foreign direct investment is always very huge, but the picture becomes even bleaker when another variable like *culture* is introduced.

The major risk that characterises FDI is perhaps cultural incongruence. Culture plays a crucial role in the life of every society. According to Nelson Mandela, the former President of South Africa, language, culture, and religion are important indicators of identity. Cultural conflict between an enterprise and its foreign host can unleash a devastating blow on the performance of the enterprise, and thus place it at a permanent competitive disadvantage.

Based on their cultural misjudgements, Rebecca Mark of the defunct Enron International and McDonald's both had bitter experiences in India and China respectively. Given that an enterprise could circumvent these inconveniencies by either licensing its production expertise to a foreign enterprise or simply export its

finished products abroad, it is astounding to note that most MNEs still prefer to undertake horizontal FDI rather than either licensing or exporting that appears to be more convenient.

The question that arises then is why enterprises prefer horizontal FDI to either licensing or exporting. Some of the factors mentioned (Hough and Neuland, 2007) in the support of what makes horizontal FDI preferable to other modes of international expansion are as follows: (1) transport costs, (2) market imperfections, (3) imitating competitors, (4) strategic behaviour, and (5) location advantages.

#### **2.9.2.1.1 Transport costs**

Transport costs may constitute the major cost driver of the exporting organisation. The higher the costs associated with transportation and distribution, the lower the profit margins of the enterprise; it thus reduces the attractiveness of exporting as an international strategy. This becomes more obvious if the products are characterised by high weight-to-value ratios like cement, paints, and steel.

This may explain why enterprises in these industries prefer FDI to either licensing or exporting. Transport costs may not be so important if the products have a high value-to-weight ratio like gold, motor vehicles, and diamonds. In this case, transportation costs have little impact on the landing costs of the products and thus play no significant role in advising against exports, or to place licensing above FDI.

#### **2.9.2.1.2 Market imperfections**

This theory serves as the basis for the explanation in favour of FDI instead of exporting or licensing as an international strategy. All things being equal, the invisible aspects of demand and supply as they affect the price mechanism should

regulate market conditions. However, where this process is disturbed by government interventions, it results in some levels of imbalances. Market imperfections refer to those factors that act against the free performance of the market system. This theory, as it relates to FDI, is also referred to as the *internalisation theory*.

Market imperfections apply to horizontal FDI in two dimensions. First, when there are limitations to the free flow of products across international borders (this was the case in the EU until 2002 under the 'block exception regime'); this makes exportation an unattractive option. Second, it also applies when it is difficult/impossible to sell expertise to foreign markets through licensing. Both situations imply that FDI is a more attractive option to expand abroad.

#### **(a) Limitations of exporting**

In almost every country of the world, home governments usually try to regulate the quantity and quality of certain products that enter the country. The quality control measures are designed to protect consumers from substandard products and exploitation (like genetically modified foods) while the quantity control is used to protect small local industries.

Governments use tariffs, quotas, and non-tariff barriers to regulate imports. While tariffs raise the landing costs of imports, quotas place a ceiling on the amount of the product that is allowed into the country.

These barriers were experienced by the Japanese automaker, Toyota in the US in the 1980s when it was operating in the country through exportation, as both voluntary and regulated export restrictions were imposed on it by the US government. The Chinese textile industry faces similar challenges across the globe nowadays. Microsoft is also not spared in some international markets like China and the EU.



## **(b) Impediments to the sale of expertise**

Every successful enterprise enjoys a sustainable competitive advantage over its competitors. This advantage normally exists in the value-chain of the organisation's operations, which is difficult for the competitors to imitate or copy so easily. This outstanding competence is always positioned within the operational process of the enterprise as a result of both the learning curves and the experience curves (Pearce and Robinson, 2007).

In order to maximise profits from this valuable capability, enterprises normally expand their market capacity by investing abroad. Nokia's strategy to expand abroad was necessary to maximise profits from its exceptional capability in wireless telephone equipments, rather than confine its operations to the Finland headquarters.

Under normal circumstances, it is expected that an enterprise like Nokia would concentrate its production facility in Finland and simply license its production expertise to foreign enterprises around the world and claim impressive royalties while it circumvents the challenges of FDI. For Nokia to have chosen to undertake FDI at the expense of licensing which appears to be more favourable, implies that FDI offers something better than licensing in this regard.

Three reasons have been identified why it is difficult to sell expertise to foreign markets through licensing. These are: (i) licensing may result in an enterprise giving away its know-how to a potential competitor, (ii) tight control over a foreign enterprise is impossible, (iii) an enterprise's know-how may not be amenable to licensing (Hill, 2007:247).

- **Giving away know-how to potential competitor**

Know-how is the major source of sustainable competitive advantage that every organisation enjoys over its competitors. As a valuable asset to and key competitive weapon for the enterprise, licensing this strategic competitive superiority to a foreign enterprise may imply training a potential competitor. The bitter experience of RCA in Japan in the 1960s readily comes to mind as the licensing agreement eventually worked against RCA.

- **Lack of tight control over foreign enterprises**

A licensing agreement clearly defines the operational relationships between the home enterprise (licensor) and the foreign enterprise (the licensee). The principles of mutual exchange and fulfilment of promises is crucial to the success of any licensing agreement. Here, strict conformity to the *modus operandi* is obligatory.

Some production processes require close monitoring, supervision, and strategic intervention from the parent body to meet the established organisational standards of the parent body, and to sustain them as well. Since licensing does not allow this, horizontal FDI appears to be more attractive in this regard.

- **An enterprise's know-how may not be amenable to licensing**

The competitive superiority enjoyed by an enterprise resides in the unbeaten operational process of the organisation, which has endured decades of competitive pressures through learning and experience. This competitive advantage has been sustainable because of its inimitability, which made it difficult for competitors to copy. It might thus be difficult for the enterprise to

codify this competency that has diffused every aspect of the organisation, clearly in a contractual agreement.

From the above, horizontal FDI is preferable to licensing where (1) the enterprise needs to protect its competitive advantage from possible competitors, (2) the enterprise needs to exercise a tight control over its know-how and, (3) the enterprise's know-how is difficult to codify or state expressly in a contractual agreement.

### **2.9.2.1.3 Strategic behaviour**

Knickerbocker (1973) expounded this theory based on his findings obtained from a close observation of oligopoly enterprises in the United States in the 1950s and 1960s. Oligopoly is defined simply as an industry characterised by a few major players like aircraft manufacturers, automakers, pharmaceuticals, and information technology. In these kinds of industries, major players are highly dependent on the strategic actions of competitors to formulate their response patterns. If one enterprise ventures abroad, others will follow suit, lest they risk being relegated to the competitive doldrums.

Knickerbocker's theory was supported by the response patterns of Toyota and Nissan as they followed Honda closely into the United States where it invested. Other conglomerates have also demonstrated the validity of this set of guidelines.

In addition to the above, the theory of "*multipoint competition*" helps to sway the argument in support of competitors imitating each other wherever they encounter in the world market. This is intended to outmanoeuvre other enterprises regarding the possibility of one enterprise dominating the market at the expense of the others. Closely related to this theory is the theory of strategic behaviour.

The theory of strategic behaviour reveals the response pattern of multinational enterprises to each other's strategic moves as a way of maintaining competitive

balance in the industry. Given that this theory did not indicate why the first oligopoly that undertook FDI did so, it thus gives more credence to the practical relevance of the theory of market imperfection in explaining why FDI could be a preferable foreign expansion strategy.

#### **2.9.2.1.4 The product life cycle**

This theory has been claimed by authors (Vernon, 1966; Wells, 1972) to influence FDI. They claimed that an enterprise that has pioneered a product will seek foreign expansion based on the stage of the product in its life cycle curves. According to these authors, a new product at the introductory phase would have to be limited to local production until the product reaches maturity stage where it has garnered enough foreign recognition that is capable of generating a sustainable profitability that would warrant introducing it to the foreign markets.

This implies that a more advanced foreign market that is accustomed to the product would have generated enough sales volume to offset the production costs of producing it in the foreign market. The argument goes further that, as competitive pressure becomes fierce, the enterprise would have to relocate the production facilities to less developed economies to gain advantage of low-labour costs, which would help position the organisation as a cost leader in the industry.

This argument is valid. Enterprises venture into foreign production only if profitability is feasible. However, the theory failed to indicate why FDI is preferable to exports, which could be more profitable by reducing marginal production costs through large-scale production. It also failed to address the need for FDI rather than licensing.

The validity of this argument is limited as a tool for international business analysis. This is mainly because it failed to provide enough proof why FDI is preferable to exporting or licensing, even when the foreign market is large enough to support foreign expansion.

#### **2.9.2.1.5 Location specific advantages**

John Dunning (1988) propounded the theory of location specific advantages, and some other authors (Buckley, 1990; Horaguchi and Toyne, 1990) have corroborated its validity. By location specific advantages, Dunning means the specific advantages that an enterprise seeks to enjoy at a particular foreign location.

Such valuable assets (like natural resources, R&D and externalities) could combine well with the organisation's capabilities to form a sustainable competitive advantage. In order to benefit from such advantages, the enterprise would have to locate where these factors are found (Dunning called this argument an *eclectic paradigm* - Johnson and Turner, 2004:110).

This theory may explain why cement firms locate where limestone is found. It also justifies the clustering of computer and semi-conductor enterprises in the Silicon Valley in California. It could also explain the logic behind the move by many MNEs that are shifting production locations to China and India to reap the benefits of a low-cost highly skilled labour. The need by MNEs to locate operations at the Export Processing Zones in foreign locations could also be used to support this viewpoint.

#### **2.9.2.2 Vertical FDI**

This is the second type of FDI. It has two forms, namely backward vertical FDI and forward vertical FDI.

The backward vertical FDI occurs when an enterprise ventures abroad to take control of the source of its raw materials. It is a commonplace business reality that MNEs embark on backward vertical integration abroad mainly in the extractive industry. Good examples of the organisations that adopt this strategy include De Beers, Alcoa, Cemex, Anglo American, Mittal Steel, BHP Billiton, and oil companies like Chevron, BP, and Engen (Mobil). Some tobacco companies like the British American Tobacco Company (BATC) invest mainly in Africa to grow their fresh tobacco leaves.

The forward vertical FDI occurs when a domestic enterprise invests abroad to market its products. The enterprise acquires or ultimately establishes its own distribution network to market its products. This option is rarely adopted by MNEs except if they are compelled to do so, because of the huge associated costs (Du Plessis, et al, 2005).

This method is mostly adopted if the competitors have tight control over the existing distribution networks. Volkswagen adopted this strategy in the United States at the beginning of its operations in that country. Pepsi Cola was forced to adopt this strategy in South Africa where Coca Cola capitalised firmly on its first mover advantages; the opposite situation applies to the two global players in the Middle East.

One may wonder why enterprises undertake vertical FDI when they can simply buy extracted raw materials from the local firms or just rely on the local distribution channels to market the organisation's products. It is logical to assume that these options would save the enterprise from the shortcomings of FDI. The theories of strategic behaviour and market imperfections lay a good foundation for reasons why vertical FDI could be preferable to the other options.

### 2.9.2.2.1 Strategic behaviour

Mainly, enterprises carry out backward vertical integration to gain control over the source of their input materials that are relatively scarce in supply and crucial to the smooth operation of the organisations. This strategic option may also be adopted to raise entry barriers and shut new competitors out of the industry (Havila et al, 2002). The enterprise may have to carry out backward vertical FDI if the input material is located abroad. This scenario validates the practical concerns of the *internalisation theory* (Hood and Young, 1979; Porter, 1990).

De Beers, one of the global leaders in quality diamonds, has achieved this successfully in the Southern Africa region along with Anglo American. The acquisition of Iscor, a South African metal organisation by the Indian Mittal Steel, gives the enterprise the outright control of one of the major steel deposits in the world.

The theory of strategic behaviour also supports the strategic move by an enterprise that integrates vertically forward abroad to establish its own distribution network as the existing outlets may be under tight control of competitors. A good example is that of Coca-Cola and Pepsi, the world's leading rivals in carbonated cola drinks. Wherever Coca-Cola enjoys the first-mover advantage, as in South Africa, it is always difficult for Pepsi to gain access to the existing distribution network; the same situation occurs in the Middle East, where Pepsi is the market leader.

The Central Selling Organisation (CSO), the marketing arm of De Beers, has been established to market De Beers' products. CSO is so powerful that it creates entry barriers to other diamond firms wherever De Beers operates.

### **2.9.2.2.2 Market Imperfections**

The theory of market imperfections gives two explanations for the justification of vertical FDI, namely the barriers in the sale of know-how and investment in specialised assets.

#### **(a) Impediments to the sale of know-how**

Technological capability is a valuable competitive asset. This kind of competence is developed over a long period of time. The resources required to achieve this is always very huge as it involves a considerable amount of finance and time into R&D, learning processes and practical application procedures. Logically, this may dissuade any enterprise from giving away its hard-earned technological expertise, just in the name of licensing. Such a mistake could be costly for the organisation as it may lead to training a potential competitor (Horstmann and Markusen, 1998).

This may explain why firms in the oil industry such as BP, SASOL, Chevron and others develop their extraction technology and use the same technology abroad through vertical FDI rather than turnkey projects. The same applies to De Beers as it develops and uses its diamond extraction and processing technology all by itself through vertical FDI. 3M is also a good example of a highly innovative but secretive organisation, just as is the case with Microsoft, Apple and Dell computers.

#### **(b) Investment in specialised assets**

The market imperfections approach also suggests that vertical FDI will take place if a manufacturing enterprise needs to invest in specialised assets, which can only use input materials from a single supplier. If left unchecked, this situation may influence a powerful monopolistic supplier to act opportunistically by raising material costs.



This situation could continue for as long as the price increase does not exceed the switching costs of the buyer. The buyer would only seek an alternative source of supply if the price increase exceeds the switching costs.

To avoid this negative situation, an enterprise may seek to acquire either the main supplier or become involved in the location of the input material (through vertical FDI) before investing in the specialised assets. This may explain why a large percentage of the total world supply of bauxite is usually transferred within vertically integrated aluminium firms (Hill, 2007).

## **2.10 The concept of FDI**

The unprecedented efforts geared towards trade liberalisation and openness of economies to international competition has resulted in increasing both the stock and flow of foreign direct investment (FDI) in modern economies (UN, 2007).

Ngowi (2001) defines FDI as an investment in the businesses of another country, which often takes the form of the setting up of local production facilities or the purchase of existing businesses. He contrasts FDI with foreign portfolio investment (FPI), which is the investment by individuals, firms, or public bodies (like national and local authorities) in foreign financial equities. Another important distinction is between the flow of FDI and the Stock of FDI.

Hill (2007) points out that the flow of FDI refers to the amount of FDI that takes place over an accounting period, normally a year. On the other hand, the stock of FDI refers to the total accumulated value (usually expressed in monetary terms e.g. US dollars) of foreign-owned assets at a given time. He further states that inflow of FDI refers to the flow of FDI into a country while outflow FDI refers to the flow of FDI out of a country.

For further enlightenment, a host nation is the foreign location where the FDI is located while the home nation is the country where the parent body/corporate headquarters of the organisation resides, i.e. the origin of the organisation.

### **2.11 The growth of FDI**

Close observation of both the flow and stock of FDI during the 1980s and recent times reveal dramatic increase and growth. It has been observed (Rivera-Batiz and Oliva, 2003) that the growth of FDI has far surpassed the growth of exports. FDI inflows grew at an annual average rate of 13.4 per cent during the 1980s and 20.2 per cent during the 1990s as compared to the annual merchandise export growth of 5.4 and 7.1 per cent respectively (Johnson and Turner, 2004).

It has also been pointed out (UNCTAD, 2005) that the flow of FDI has increased from about \$25 billion in 1975 to a record \$1.3 trillion in 2000, furthering the argument that the stock of FDI that exceeded \$5.7 trillion by 2000 was due to the strong growth of FDI. Versi (2003:11) puts the stock of FDI at \$7.1 trillion by 2003. About two years ago, the flow of FDI figure was quoted in 2005 at US\$897 billion (UNCTAD, 2006). This trend reflects some level of consistent growth in both the stock and flow of FDI.

Although the share of the developed world of global FDI continues to dominate the picture, so also is the developing world's share increasing continuously. In 2004, the developing world accounted for 25 per cent of the world stock and 39 per cent of the total inflow (UN, 2006).

### **2.12 Forms of FDI**

There are two forms of FDI namely mergers and acquisitions, and greenfield investments. *Mergers* occur when a domestic enterprise combines its production

facilities and processes with those of a foreign enterprise and the two previously separate enterprises become amalgamated to form a single organisation (Pearce and Robinson, 2007). This kind of foreign market penetration strategy could be adopted to leverage production facilities and processes, if the levels of competition are intense (Du Plessis, et al, 2005).

*Acquisition* on the other hand, occurs when a domestic enterprise 'buy-over' a foreign enterprise and takes total control of both the production and administrative processes of the acquired enterprise.

### **2.12.1 Merits of mergers and acquisitions**

The major benefits derivable from the mergers and acquisitions of foreign enterprises include the following:

- (a) Mergers and acquisitions are easier to carry out than starting investment processes from the scratch. The process of building a new production facility takes longer than sealing a take-over deal. Since time is of the essence in reaping first mover advantages, mergers and acquisitions (M&A), could thus be preferable.
- (b) It might be a better idea to acquire/merge with a foreign enterprise in order to take advantage of both the tangible and intangible assets of the acquired organisation. The tangible assets include production facilities like plants and machines, land and buildings, stock items, and possibly cash.

The intangible assets include goodwill, patent rights, brand loyalty, customer relations, a viable distribution network, and a distinctive operational value chain, among other resources. A good example is

the acquisition of Miller, a leading US brewery by South African Breweries to augment its US operations.

(c) Mergers and acquisitions of foreign enterprises may be necessary to benefit from the synergy of operations between two enterprises. It also makes it possible to transfer knowledge, skills, techniques, and other significant spillovers that allow for better performance of the combined firms (Pearce and Robinson, 2007).

(d) Mergers and Acquisitions also lower the costs of doing business abroad as the incidence of bribes, policy barriers and other forms of uncertainties that raise the costs of doing business abroad are circumvented.

### **2.12.2 Greenfield investment**

The second type of FDI is a greenfield investment. This occurs when an enterprise establishes a wholly owned production facility in a foreign location from the scratch. This kind of FDI could be necessitated by an enterprise's strategy to identify fully with the foreign community thereby winning the peoples' loyalty.

The strategy could also be adopted to entrench the organisation strongly in the marketplace thereby making it very difficult for competitors to penetrate the market. Although, greenfield FDI could be more expensive and daunting in the short run, the long run benefits of the strategy could far offset the associated shortcomings.

## **2.13 Importance of FDI**

### **2.13.1 Introduction**

The major contribution of investments to the improvement of human comfort, which Krause referred to as the 'standard of living' has been remarkable. In addition, the findings of a research project (Sachs and Warner, 1995) that covered more than 100 countries over the period between 1970 and 1990 reveal that there is a strong relationship between a country's openness to investment and its economic growth.

The research also finds a 'strong association' between an economy's openness and its growth, both within the group of developing and the group of developed countries. On the one hand, the findings indicate that the group of developing countries with open economies grew at 4.49 per cent per year while the closed economies grew at 0.69 per cent per year.

On the other hand, the group of developed economies with open economies grew at 2.29 per cent per year while the closed economies grew at 0.74 per cent per year (ibid). Although this assertion did not go unchallenged as Rodriguez and Roderik (2000) identify poor macroeconomic performance and high levels of corruption (peculiar to Africa) as the possible cause of the low growth recorded by closed economies in the developing world rather than the economies themselves 'being closed'; there is supporting evidence to justify the correlation between economic openness and growth.

Tomohara (2004) also establishes a link between investment and economic growth. According to him, the openness of an economy enhances the international participation of domestic enterprises. This may help explain why the contribution of FDI to global economic growth has been meaningful.

Specifically, the UN stated in its World Investment Report of 2003 as quoted by Versi (2003), that the world's FDI growth, which has consistently been high, explains the reason why so many countries are enjoying unprecedented levels of prosperity.

## **2.14 Benefits of FDI**

### **2.14.1 Introduction**

The benefits derivable from FDI can be viewed from the perspectives of the contributions made by the MNEs to both the host and the home economies. This approach is deemed appropriate because FDI and MNEs are inseparable; it is mostly the MNEs that carry out significant scope of FDI. Furthering this argument, Tomohara (2004) found from research that foreign direct investment by multinational enterprises yields a larger market and therefore, fosters growth.

### **2.14.2 Benefits of FDI to the home economy**

The positive effects of FDI on home economies varies and depends on a number of variables such as the amount of initial capital involved, foreign market conditions and the political economy of the host country, amongst others (Abramovitz, 1989; Perez, 1983; Shafaeddin, 2005). The following are identified benefits that the home economy may likely receive from FDI outflows (Hill, 2007:276-277).

- The balance of payment/trade advantage - FDI helps the home economy to improve its balance of payments account. This is achieved as the MNEs remit the proceeds of their foreign investments back home. In the same vein, FDI helps to improve the balance of trade of the home country. It achieves this by sourcing production factor inputs like raw materials, expatriates, capital, machines, and equipment from the home country; all of which increases exports for the home country.

- FDI also helps to create more *job opportunities* in the home economy. Sourcing of input materials from the home country leads to an increase in production capacity to meet the new demand, thereby bringing about an increase in job creation in the home economy.
- Skills and knowledge acquisition - MNEs learn *new skills and technology* from abroad, which are transferred back home to improve production processes. General Motors and Ford investments in Isuzu and Mazda respectively are good examples of how US enterprises invest abroad to learn about new production processes. Japanese enterprises are leaders in using FDI to source technology from abroad, most especially, from the United States.

### **2.14.3 Negative effects of FDI on the home economy**

#### **2.14.3.1 Introduction**

The impressive contributions of FDI to the world of investment did not go without criticism. In the recent past, a series of protests and violent demonstrations against globalisation, and more specifically, FDI have taken place. These protests mainly centre on the perceived (and felt) negative effects of FDI on the home country's economy and its environmental effects on the host economies, among other reasons.

The anti-globalisation protests have been more concentrated in the Western World (Europe and US) - the major sources of FDI in the world. Its record began with its first organised protest in Seattle (United States) in December 1999, followed by its first martyr in Genoa (Italy) in 2001, and the recent (2007) demonstrations at the G8 summit in Heiligendamm (Germany).

Some of the identified problems that FDI causes for the home economies are the following; -

- The balance of payment problems- The initial capital outflow to finance the foreign projects is always very huge. It is expected that remitting operation profits back home would offset the capital outflow; but this is not always the case. In most cases, organisations normally reinvest their foreign earnings for a long time to enable the foreign affiliate grow.

The plough-back profit at a discounted rate indicates that such funds may remain offshore for a long period of time. This problem is further compounded if the foreign subsidiary turns out to be an import substitute for previous imports from the home economy. This may result in the home economy losing more exports, thereby creating, or aggravating the balance of trade/payment problems of the home country.

The problem of import substitution could also cause *unemployment in the home country*. A lack of exports in the affected sector could mean disaster for the home economy as experienced in the United States' textile industry. For example, Harwood Industries, a US clothing manufacturer closed its US operations and shifted its production to the Honduras where it paid just about five per cent of its US labour costs.

Recently, many US textile manufacturers are either outsourcing or wholly producing their goods in Asia, thereby causing structural unemployment in the US textile industry. Motor vehicle manufacturing has gradually joined the bandwagon of both outsourcing and locating abroad. South Africa currently faces a similar problem in its textile and mining industries.



## **2.14.4 Benefits of FDI to the host nation**

### **2.14.4.1 Introduction**

Almost all the nations of the world compete with one another to attract as much FDI as possible. The relative contribution of FDI to domestic capital formation or GDP has been significant. If integrated into a strategic concept of productive capacity building and upgrading, the direct impact of FDI inflows on domestic income and investment creation has been substantial. It combines both tangible and intangible resources that can contribute to economic development in the host economy (UNCTAD, 2006).

Ngowi (2001) supports this argument as he argues that FDI can be an engine of economic growth in a host economy. In his opinion, ten advantages are derivable from attracting FDI to a nation (the host nation).

These advantages are as follows: (1) The creation of employment, (2) It is a vehicle for transferring technology, (3) It provides superior skills and management techniques, (4) It helps with the process of capital formation, (5) It facilitates access of local enterprises to international markets, (6) It uses local resources more efficiently and productively, (7) It increases labour rights, (8) It uses environmentally clean technology, (9) It observes human and labour rights, and (10) It creates many linkage-effects in the economy, both forward and backward.

For the purpose of this research, the listed benefits of inflow FDI by Ngowi (2001) will be further elaborated below, to enhance a better understanding:

- Employment opportunities - According to Meyer (2004), the contribution of greenfield investments on employment is more significant than other forms of FDI (mergers or acquisitions). He observes that greenfield projects create new

businesses thereby more direct positive effects on employment, and domestic values are added.

Versi (2003) quoting the UN's World Investment Report of 2003 points out that FDI has created about 53 million jobs worldwide. Hill (2007) reiterates this fact by observing that the US labour force of foreign affiliates grew at 1.4 per cent contrary to the 0.8 per cent growth recorded in the home enterprises between 1989 and 1996.

- The transfer of technology - According to the UN (2006), the belief by governments in the positive impacts of FDI on economic growth, increased productivity and technology transfer, has influenced policy reforms aimed at creating investment friendly environments to attract as much FDI as possible.

Given this background, Meyer (2004) argues that it is export-oriented FDI that helps in transferring knowledge on operating production processes. The reason is that, this form of FDI ensures interaction between foreign enterprises that offer such opportunities and the local enterprises that benefit from them.

Meyer further reveals that MNEs use FDI to access R&D competences around the world, either by locating near major centres of innovation (like Silicon Valley) or by acquiring enterprises with R&D capabilities. This method was prominent among the Japanese MNEs that invested in the United States.

Another way, through which spillover occurs, is when local enterprises imitate foreign organisations. Elmawazini et al (2005), supports this position by indicating that the higher the share of foreign ownership and control in a nation's business sector, the more advanced technologies can spill over from foreign to local enterprises. Chung (2001) further observes that these

intangible capabilities are either purposefully or inadvertently transferred to incumbent enterprises through ‘interactions.’

- Superior skills and management techniques - It is a general conviction that foreign firms bring along with them superior operational skills and expertise to the host nation. For example, the Wal-Mart’s high technology inventory capability. These same outstanding capabilities follow Wal-Mart across the globe, thereby helping to improve the operation standards in the retail sector.

This yields higher delivery levels, result in efficient performance, and increased prosperity in the home economy. Correa and Kumar (2003) further the argument in support of this knowledge spillover effects on the host economy.

- Capital formation - FDI helps the movement of capital flow from the home country to the host nation. This possibly helps to boost the capital formation capacity of the host nation. FDI has consistently been the most stable component of cross-border private capital flows (UN, 2007).

Hill (2007) posits that MNEs, by virtue of their large size and financial strength, have access to financial resources not available to host country enterprises. Hill cited the example of PDVSA, the state-owned Venezuelan oil enterprise that invited foreign investors to raise capital to upgrade its existing facilities to state-of-the-art technology, which was essential for the organisation to remain competitive in the highly challenging oil industry.

- Accesses to international markets - MNEs are generally large enterprises with strong financial and operational capabilities that make it easier for their foreign affiliates to access world markets. This is made possible by either using

the existing distribution network or by acquiring one of the most prominent distribution networks in the host nation.

FDIs can be seen as a vehicle for the host nation to access the international marketing and distribution arena by linking with the global network of the MNEs. Botswana reaps this benefit through the Korean automobile manufacturer, Hyundai.

Coca-Cola, Wal-Mart, Unilever, and many other MNEs have demonstrated this possibility in many instances. One could thus logically posit that MNEs play a pivotal role in creating a link between the rich and poor economies by connecting the divergent economies to a single marketplace through a single (global) marketing approach (Hough and Neuland, 2007).

- Use local resources more efficiently and productively - The presence of foreign enterprises in the host economy, signals to the local enterprises that they should be more competitive in order to maintaining their market share. To stay relevant in the market requires offering what other competitors cannot offer. To be price competitive suggests offering high quality products at the lowest possible price. Locating production facilities where the lowest costs are achievable may help to realise this goal or by improving the production process.

In line with this argument, Meyer (2004) is of the opinion that increased competitive pressure on local enterprises may act as an incentive for them to improve their operational efficiency to stay in the market or be forced to exit the market. Chung (2001) further supports this argument as he states that best-practice markets, situations where market conditions force enterprises to be

creative and innovate, are more likely the sources in which new capabilities are developed.

- Increase product diversity - The presence of foreign enterprises in any industry helps to improve the quality of product offerings. The new entrants from foreign nations need to offer something unique in quality and variety to outperform the host nation's enterprises that are comfortably positioned before the arrival of the new entrants.

McDonald's demonstrates this by offering customised products in various foreign locations. Caterpillar applied the same policy in Germany as it was forced to modify its products to suit the German tastes. Johnson and Johnson also applies this strategy in its foreign affiliates.

- Forward/backward economic linkages - Tomohara (2004) observes that MNEs are eager to invest abroad to exploit the opportunities of differences in relative factor endowments. MNEs may create forward economic linkages by exploring overseas markets, or backward linkages to source factor inputs (supplies).

In both cases, linkages generally improve the efficiency and effectiveness of the host economy as it aids diffusion of capabilities. The leverage effect of synergy that subsists within the organisation's network also has a capacity spillover effect on the host economy.

- Advanced economically friendly technology - Eskeland and Harrison (2002) conducted a research on the pollution and technology effects of MNEs on the local environment. The research found that foreign investors are more efficient in using energy, an important factor in environmental impact determination.

Christmann and Taylor (2001) also found that an enterprise's international linkages help to regulate environmental standards through adaptation of firms to the industry's self-regulation standards.

The establishment of quality standards for EU products and products entering the EU further allays fears of technologically inferior products. This forces many enterprises to subscribe to the principle of environmental friendliness and corporate social responsibility.

The Best Practices Acts in the United States also help enterprises that originate from that continent to be sensitive to the environmental implications of their foreign operations. The United Nations has also established ten principles under its Global Compact to regulate MNEs foreign practices (UN, 2006).

The recent embargo placed on some airlines by the EU as they were classified as 'unsafe and environmentally unfriendly,' stresses this point of view. This helps to regulate pollution, environmental degradation and, sub-standard products which consumers and the entire society might be subjected to, if those aspects are not regulated.

## **2.14.5 Costs of FDI to the host nation**

### **2.14.5.1 Introduction**

Bhagwati (2004) points out that the role of MNEs in emerging economies is a key aspect of contemporary disputes over the contributions of globalisation to the recent economic growth and development of developing economies. Some authors (Havila, Forsgren, and Hakansson, 2002; Akindele, Gidado, and Olaopo, 2002) argue that MNEs capitalise on their advantageous position regarding their power, size and access to valuable resources in order to obtain consensus from the host government.

Versi (2003) observes that it is not all FDI that benefit the host country. Chung (2001) observes critically that many developing nations generously encourage FDI assuming that it is beneficial, whereas evidence of negative outcomes from such associations has led to many states reconsidering their FDI policy. Rodrik (1999) observes that much recent policy literature is filled with extravagant claims that FDI leads to positive spillovers, but the evidences show some sobering experiences.

For the purpose of this research, the disadvantages of FDI for the host nation identified by Hill (2007:275), namely the adverse effects on competition, adverse effects on the balance of payments, and national sovereignty and autonomy, will now be considered. It is also considered important to include job loss, dumping, and exploitation to the list of the disadvantages mentioned above.

#### **2.14.5.2 Adverse effects on competition and dumping**

Although it was observed earlier that MNEs help create competition in the host economy, a further critical analysis may present something gloomy; in actual fact, MNEs may kill competition. For example, the European Commission (now the European Union) intervened in 2000, under Anti-competition Acts, to regulate the mergers of AOL-Time Warner as the merger was construed to be a move towards creating a monopoly in the entertainment industry.

Similar rulings helped to keep the insurance industry in Europe competitive despite a series of mergers that took place in the 1990s. A series of confrontations between Boeing and Airbus have always ensued from the anti-competition behaviours of both parties (Hough and Neuland, 2007).

Backed by the reputation of the parent body with the ability to raise large capital and with access to other strategic capabilities, foreign affiliates can offer high quality

products at lower prices. If the prices offered are below cost prices (dumping), local producers may not be able to compete with the lower prices offered by the foreign enterprise.

This argument justifies the crowding out theory as local enterprises are worked out of production or the market. This situation may result in the MNE emerging as a monopoly in the industry, thereby acting opportunistically.

Ford US is at the point of collapsing due to fierce competitive pressure from Japanese automakers within the US market. Recently, General Motors was forced to close a larger part of its US operations due to stiff competition from Toyota (Corolla), a Japanese car manufacturer (BBC News). Many local textile manufacturers in South Africa (like Fishy Fashions) have been crowded out of the market because they find it almost impossible to compete with Asian cheaper imports.

#### **2.14.5.3 Adverse effects on the balance of payments**

Foreign enterprises inject huge investment capital into the host economy, when they make foreign investments. As operations flourish, profits generated from foreign operations are sent back home. The more foreign currency that leaves a local economy, the more pressure there is on foreign reserves; these kinds of currency disturbances could possibly cause or exacerbate the balance of payment problems for the host nation (Magubane, 2004). This situation could worsen if foreign affiliates import most of their input materials from abroad, which will exert pressure on both the balance of payments and trade balance.

MNEs may also indulge in the manipulation of transfer pricing of imports from one subsidiary to the other with the aim of circumventing taxes, or better still, to move



huge amounts of money out of the host economy. This may further affect the balance of payment of the host economy (Correa and Kumar, 2003).

#### **2.14.5.4 Negative effects on national sovereignty and autonomy**

Given that policy frameworks and governing principles are relaxed to attract FDI (Meyer 2004; Kirkpatrick, Parker and Zhang, 2006), this may imply that governments of attracting nations do compromise on some legal principles pertaining to labour exploitation and abuse, environmental issues, and monetary/fiscal matters, which are always areas of major concerns for foreign investors.

This feeling is in the agreement with the general observations made by Meyer (2004), Cerny (1994), Eskeland and Harrison (2002); that host countries are always eager to attract investments and thus compromise their standards under pressure from MNEs; a move that undermines the democratic principles of the sovereign state, and sometimes results in the exploitation of the local resources (Akindele et al, 2002).

There is the conception that MNEs locate only where they can presumably exploit situations and conditions (ibid). Some observers fear that the strong bargaining power of MNEs leads to a lowering of wages in the host nations (Cerny, 1994; Henriot, 1998; Palley 2002). This supports accusations regarding the alleged practice of sweatshops by MNEs in developing countries like China and India, not to mention the underdeveloped countries of Africa where child labour is presumed to be customary.

Gumbel (2005) studied the impact of US buyouts in Europe and discovered that the general perception of Europeans regarding the takeovers was negative. He quoted Mr. Franz Muntefering, the former chairperson of the Social Democratic Party (SDP), who openly compared these investors to 'swarms of locusts' that fall on enterprises and devour all they can before moving on. Mr Muntefering was quoted as saying that

these financial investors do not waste any thought on the people whose jobs they destroy as a result of their downsizing.

Gumbel further observes that the amount of European buyouts by American enterprises was more than \$25 billion in 2004. This by implication may place more of the national economic capacity in the hands of foreign investors. The caution exercised by South African courts to limit the amount of Barclay Bank's buyout in the Amalgamated Banks of South Africa (ABSA) could be attributed to the shortcomings that are peculiar to such investments around the world; as they have always resulted in creating a potentially unmanageable level of system risk.

Hilary Joffe in the *Business Day Newspaper* was quoted by *African Business* (2005), to have furthered this argument when he observes that the more economies depend on hot money, the more vulnerable they are to emerging market crises or sudden changes in foreign investment sentiment. This was recently (2008) experienced in China and the United States. South Africa was also not spared in the financial swings.

Balaam and Veseth (2005) echo this sentiment when they cite the Asian currency crises of 1997. The Asian currency crises crippled the entire economy to the extent that the South Korean government was compelled to seek a loan of \$55 billion from the IMF to resuscitate the economy. As usual, the IMF came up with loan conditions that the Korean government would close illiquid financial institutions; a move that caused 16,000 gainfully employed Koreans to become jobless.

#### **2.14.5.5 Job losses, exploitations, and lowered democratic principles**

As stated earlier, the process of attracting inward FDI necessitates compromising some democratic principles of the government. This may imply making some

concessions to attract these investors – a move that could lead to an opportunistic behaviour by the foreign investors.

For example, the sympathy walkout by British Airways' ground staff at Heathrow airport in London that caused national embarrassment in 2005 was set off by the loss of thousands of jobs, coupled with pay cuts by the Gate Gourmet management (a subsidiary of Texas Pacific, an American business).

Because of Airbus's restructuring programme in 2007, about 10, 000 jobs will be lost. France will be worst hit with 4,300 job losses. Germany will see 3,700 jobs go while the UK and Spain will see 1,600 and 400 jobs cut respectively. Airbus chief executive Louis Gallois indicates that the organisation will not force any compulsory retrenchments, but he was uncompromising on the strategy (BBC news).

These are good examples of the fickleness of foreign investors when it comes to profit maximisation. A similar opportunistic behaviour was demonstrated by Ford in England when it threatened to move its production abroad if the Labour Union did not back down on its demands for a pay increase (Hill, 2007).

Similarly, Wolfgang Bernhard, the new CEO of Volkswagen forced the union to agree to work more for less pay, as he threatened to relocate to Portugal from Germany if the trade union refused to comply with his demands (Gumbel, 2005). One of the German's huge construction enterprises, IG Bau even agreed to a 40-hour week without additional pay as its members consider it better to work for a low wage than not to work at all.

The traditional era of coddling workers under the socialist and nationalist rhetoric is long gone in France. Former Prime Minister Dominique de Villepin will never probably forgive himself for the outcome of his experimental labour laws, which

almost plunged France into a civil war in 2006. The Germans metalworkers' Union, the largest trade union in the country, also cried foul over the acquisition of MTU by Euro Engines. The union's objection to the deal was centred on continued job losses, which exceeded 1,000 out of the 7,400 staff capacity (Gumbel, 2005).

#### **2.14.5.6 Intervention mechanisms**

This concern has necessitated the promulgation of a series of laws and regulations by the United Nations to forestall opportunistic behaviour by MNEs. Some of the codes that compel MNEs to adhere to Corporate Social Responsibility include the MNE declaration of the International Labour Organisation (ILO), The OECD Guidelines for Multinational Enterprises, The United Nations' Global Compact, CSR work conducted by UNCTAD, and the International Finance Corporation's Performance Standards on Social and Environmental Sustainability (UN, 2006).

Although, some of these instruments are not universally binding, they do articulate a set of principles to guide the global operations of enterprises and their social policies (ibid).

### **2.15 Determinants of the direction of the flow of FDI**

#### **2.15.1 Introduction**

Having considered both the benefits and negative effects of FDI, it still appears to be a viable proposition to try to attract as much FDI as possible. This is imperative, as FDI's are considered a valuable instrument in boosting the national economy while simultaneously raising the standard of living of the people (UN, 2007).

To attract FDI, some conditions are seen as prerequisites. Citing UNCTAD's 1998 World Investment Report, Ngowi (2001) identifies three types of FDI; and his views

are supported by Versi (2003), and Ghauri and Buckley (2002). These authors share the feelings that it is the investors' motives/kinds of investor that determine the specific considerations in choosing a locale that best suits the investment expectations. A further analysis of these kinds of investors follows below:

### **2.15.2 Types of foreign direct investors**

Akinkugbe (2005) observes that one may argue that since foreign investors have primary commercial motives, they will only choose such countries where a high rate of returns on their investments can be assured, and where they will not have to commit so much of their initial investable resources to infrastructural upgrading.

To attract FDI, it is more of the investors' intention that determines which kind of FDI goes where rather than anything else. Chung (2001) suggests that investing foreign enterprises act strategically, which demands that incumbents (both government and local enterprises) should also respond strategically towards attracting and sustaining foreign direct investment. Evidence of this strategic approach to FDI is located in the findings of empirical research (Bruce and Chang, 1991; Walter, 1999; and Robert and Papanastassiou, 1999) where it was found that investment motives are functions of industry conditions.

#### **2.15.2.1 The market seeking investors**

The aim of these kinds of investors is to market their products. The production facility is located in the home country and they seek foreign markets for the manufactured products, mainly through exportation. Chinese and other Asian textile manufacturers are good examples. These kinds of investors consider among other things, the following:

- The market size - the population size of the market is of essence here. Besides the numerical strength of the location, the income level of the location also counts. A market could be big in size but with low per capita income. This implies that the purchasing power of the huge population may be low. India and many African nations like Nigeria and Mali are good examples.

Also of importance is the issue of culture. Du Plessis et al (2005) are of the opinion that culture and social change are essential in explaining consumption. A big market with a fragmented culture, complex traditions, and cumbersome ethics may not be profitable enough to serve. This is due to the fact that a series of fragmented customisation steps would be required to reach out to all the fragmentary target customers; and this might increase the costs of production.

Serving a country with dual characteristics like South Africa (with both Western and African characteristics) may be challenging, as there might be a need to satisfy diverse tastes and fashion, and the income levels that are characterised by numerous cultural incongruence (Du Plessis et al, 2005).

- Market growth - the growth potential of a market is important to determine its long-term profitability. Sometimes, it might be expedient to locate in a place that currently offers few sales, provided that it has the prospect of future growth. Market growth can be viewed from the perspectives of population increase and increase in per capita income or better still, a better income redistribution mechanism.

South Africa ranks high among many African and Asian countries that have the potential for market growth due to its continuing economic growth, redistributive mechanism, relatively stable interest rates and moderate inflation.

Access of the location to regional trade blocs and the entire global market is also important. A country that has trading agreements or pacts with both regional and economically powerful nations would offer good prospects for market growth, and as such, more likely to be considered a viable location by this kind of investor. South Africa rates high here due to its various trading pacts with the EU and other Asian countries like India, Brazil, Mexico, Russia and China.

- Market and country structure - specific consumer preferences also count. As stated earlier, a fragmented market may not be profitable to service. More important is the issue of distribution channels. The more concentrated and centralised the distribution network is, the more difficult it is to penetrate such a market.

To penetrate a country like South Africa where a few giant conglomerates control the entire distribution channel tightly would be difficult (EIU ViewsWire, 2004). Another consideration is customers' tastes and fashions. If consumers' preference requires little local customisation as in bar soaps or chocolates, it would be easier to sell en-masse to reap the benefits of large-scale production (Du Plessis et al, 2005).

#### **2.15.2.2 Resource/assets seeking investors**

The second type of investors are those seeking locations that are more endowed with raw materials, low-cost skilled/unskilled labour, technological innovations, and other valuable assets like brand names; physical social amenities and infrastructure such as a good road network, a reliable power supply, water, telecommunications, seaports, and airports.

Principally, the conditions necessary to attract this kind of FDI are rarely sufficiently available in Africa. Emerging economies typically have fewer sophisticated markets,

supporting institutions and fewer location advantages based on created assets, such as infrastructure and the human capital necessary to attract this kind of investors (Hoskisson et al, 2000; Narula and Dunning, 2000)

India rates high on hi-tech labour skills that are relatively cheaper. China and South Korea are also well developed regarding labour and infrastructure to attract this kind of investments. Silicon Valley in the United States offers a competitive opportunity as well for investors in semi-conductors and computers.

### **2.15.2.3 The efficiency seeking investors**

The efficiency seeking investors are the third type of FDI. These kinds of investors seek locations that offer the least costs possible in comparative terms. They look for locations that offer the cheapest specialised labour, strategic multilateral business partnerships with strong economic agencies like NAFTA, EU-ACP, the African Growth and Opportunity Act (AGOA), and the Everything But Arms (EBA) initiative.

Africa rarely has the necessary facilities to attract efficiency-seeking investors. African countries are rarely blessed with the developed human capital required to train employees and make them readily available at reasonable global competitive rates. Notwithstanding, some African regional trade blocs are linked to powerful world trading blocs, thereby making it possible to access larger world markets.

Modern forms of FDI are showing a drastic move away from manufacturing to services and technologically intensive activities (UN, 2007). It has thus become essential to invest in technological assets, facilities, and skills that are the major prerequisites to attract the new category of modern FDI. Ngowi (2001) indicates that foreign enterprises will locate their industrial activities in countries with a superior quality of national infrastructure.



## **2.16 MNEs and national economies**

Porter (1990) observes that national prosperity is created through national values, culture, economic structures, institutions and histories. He states further that differences in these factors contribute to the competitive success of any nation because they form the basis of this nation's competitive advantage.

The revolutionary changes in national incomes, productive techniques and, improved operational processes have resulted from technological advances in international infrastructure like banking, ICTs, insurance, and transportation. Such developments have somewhat facilitated both the opportunities to learn about investment opportunities abroad, and the means to reap those benefits (Korth, 1985).

Based on this analysis, the findings of David Ricardo (comparative advantage), Heckscher-Ohlin's (factor proportions), through to Porter's Competitive Advantage of Nations all clearly establish the practical inevitability of foreign investment as the spring-board upon which a nation's growth and prosperity can be built.

MNEs play a very critical role in shaping modern investment history. MNEs, using their tools of foreign expansion (FDIs), represent an increasingly important element of global commerce and factor mobility (Rivera-Batiz and Oliva, 2003; Correa and Kumar, 2003). They usually pervade host nations through the inflow of bundles of resources like capital, production techniques, organisational and managerial skills, marketing know-how and market access. MNEs can therefore be expected to contribute more to the host nation's growth than the domestic investments (Ibid).

## **2.17 The flow and content of FDI in Sub-Sahara Africa**

According to the UN (2007), the direction of FDI seems to be leaning more to the developing world now than it has ever done before. The publication recalls that the

share of developing economies in the global share of FDI has risen from 20 per cent in 1978-1980 to 35 per cent in 2003-2005.

Specifically, the African continent attracted about 4.4 per cent of global FDI inflows in 1970, of which Sub-Sahara Africa claimed about 3.8 per cent. The post 2000 Africa has only managed to record an average of 1.8 per cent of the global share, of which Sub-Sahara Africa (SSA) was able to attract about 1.1 per cent of the global share up to 2004. During these periods, the major focus of foreign investors in Africa was on energy exporting countries and solid mineral resources, which accounted for 63 per cent of all mergers and acquisitions in 2005 (Business Africa Nov., 2005).

The volatility of FDI inflows to Africa reflects the dominance of some mega projects such as hydrocarbons in Chad, Angola, Nigeria, and Ethiopia; mining schemes in the Democratic Republic of Congo (DRC) and Mozambique coupled with privatisation transactions and mergers and acquisitions in North Africa and South Africa (ibid).

### **2.18 Chapter summary**

This chapter focuses on the general conceptual appraisal of FDI. It looks in some detail, at the evolution of investment and the role of globalisation and its protagonists (GATT and WTO), in conjunction with the conceptual overview of FDI. The chapter critically evaluates the general principles, the supporting concepts and practical analysis of FDI as it relates to the investors, the host and home nations, the interested and affected nationals, and the international business environment.

Having related the concepts to Sub-Saharan Africa, the following chapter (three) will attempt to relate the concept of FDI discussed above to the South African context.

## **CHAPTER THREE**

### **THE THEORETICAL FRAMEWORK, PRACTICE AND CONTENTS OF FDI: SPECIAL REFERENCE TO SOUTH AFRICA**

#### **3.1. Introduction**

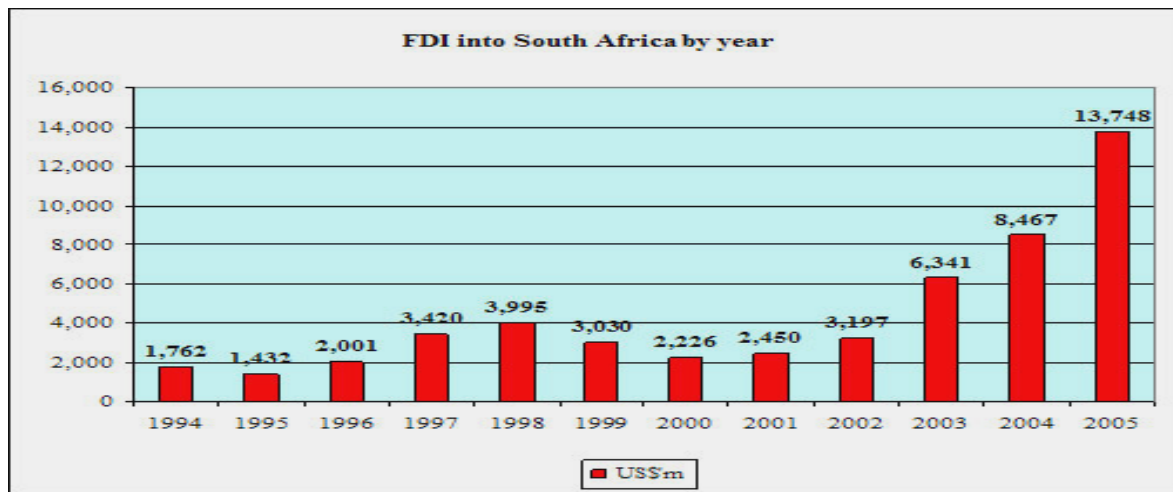
This chapter will look at the trend of FDI inflows to South Africa. This is intended to reflect how the change in government's macroeconomic and other investment related policies have influenced the general perception of investors about South Africa as an investment destination.

#### **3.2 The flow of FDI to South Africa**

In 2005, South Africa showed an improvement of 15.8 per cent over 2004. The inward stock sharply increased to \$6.4 billion, representing about 21 per cent of the region's total (UN, 2006). This sharp increase was due to a single merger and acquisition (M & A) that took place between ABSA Bank of South Africa and Barclays Bank of England for about \$5 billion.

The following graph (Fig. 3.1) reflects the dynamics of FDI inflows to South Africa from the period of political emancipation in 1994 up until 2005. This is intended to depict the trends of this inflow over the 11-year period:

**Figure 3.1: FDI into South Africa by year**



*Source: Business Map, 26 March 2007*

Figure 3.1 shows inconsistency in the flow of FDI into the country over the period under consideration. FDI inflow between 1994 and 2002 was considerably low. The gentle increase in inflow FDI between 2003 and 2005 was largely influenced by mergers and acquisitions that took place over the period.

In 2006, the figure for FDI inflow to South Africa slumped into negative (-US\$323 million) (UNCTAD, 2007). Even in 2004 when the inflow figure was US\$799 million, it was still lower than the 1990-2000 figures when it was quoted at US\$854 million (ibid). Poor still, according to the FDI Inward Performance Index (2008), South Africa slumped to 120<sup>th</sup> in 2006, from 105<sup>th</sup> in 2005 out of the 141 economies covered by the survey.

### **3.3 The composition of FDI in South Africa**

The composition of FDI in South Africa will be viewed from the activity dimensions of the MNEs in the country namely the primary sector (extraction of mineral resources and agriculture), the secondary sector (manufacturing/value-adding

activities), and the tertiary sector (IT, telecommunications, banking, finance, insurance, the market management, and general business services).

**3.3.1 The primary sector**- this sector consists of activities that involve the locating and processing of natural materials that have never at any point in time, entered any form of value-adding process. Such activities include the mining of minerals, agriculture and farming, timbering, fishing and so on.

Given that South Africa is one of the most endowed nations in natural resources, and undoubtedly, the prime source of raw materials in Africa (UN, 2006), it is not unexpected that her strong point is located in the primary sector. The primary sector comprises the following:

**(a) The mining sector** - South Africa's mining industry is one of the most technologically advanced in the world. The country is uniquely synonymous with deep-level extraction that could go to a level of as much as 3000 metres below the earth's surface. Mining clustering resulted from the technological advancement that characterises the mining industry. This perhaps contributed to having the best miners in the world either based entirely in South Africa or connected to the world from the South African shores (Going Global Career Guide, 2006: 66-67).

This sector is prominent in the country's economy as it accounted for about 30 per cent of the total exports in 2003, employing more than 600,000 people, and directly influencing more than six million lives in South Africa (ibid).

**(b) The agriculture sector** - The agriculture sector of South Africa is one of the most productive in Africa. This industry is renowned for its mechanised system, embedded by state-of-the-art technology that has resulted in a world-class forestry industry that

employs more than 200,000 people. The industry provides most of the pulp and paper needs of the country and also contributes noticeably to the country's exports.

**3.3.2 The secondary sector** - This sector is comprised of all the activities that relate to adding value to the produce of the primary sector. It includes, but is not limited to processing, fabricating, shaping/reshaping and packaging, distributing and marketing of the produce of the primary sector.

**(a) The manufacturing industry** - South Africa is rapidly changing from a producer of raw materials to an industrialised nation that produces both raw materials and manufactured products. According to the *Going Global Career Guide* (2006:33), "South Africa has developed a diversified manufacturing base that has demonstrated resilience and the potential to compete in a global economy." The manufacturing industry is dominated by motor vehicle assembly; chemicals; textiles; electronics; IT and communications; metals; and foodstuffs.

**(b) The automobile industry**- this industry can practically be called the cornerstone of FDI in the country and after mining and financial services, it features prominently. There are more than 220 automotive component manufacturers in South Africa, and another 150, which supply the industry on a non-exclusive basis. Europe as a whole, accounts for about 74 per cent of component exports from South Africa. World-class vehicle manufacturers like BMW, Ford, Volkswagen, Daimler-Chrysler and Toyota are clear leaders, while the major component manufacturers include Arvin Exhaust, Bloxwitch, Corning, and Senior Flexonics (southafrica.com).

**(c) The chemical industry**- This industry is among the most developed and largest of its kind on the African continent. The industry is highly diversified and complex, characterised by highly developed technological innovations like the gas-to-liquid

technology where SASOL oil, a giant South African oil producer is prominent. AECI and Dow Sentrachem are also significant role players in the industry.

**(d) The metal industry** - the metal industry represents about a third of the total of South Africa's manufacturing capacity. Based on its well-developed system, vast natural deposits and supportive infrastructure, the industry is generally large and promising.

**(e) The aerospace industry** - Another crucial area of interest in the manufacturing industry is the aerospace industry. The national history of South Africa favourably positions the country as a capable/potential global player in this industry. South African aeronautical firms play active roles in designing, and manufacturing of hi-tech parts for the state-of-the-art civilian and military aircrafts for reputable international aerospace organisations like Boeing and Airbus (southafrica.info).

**3.3.3 The tertiary sector**- This industry is characterised by the production, distribution and delivery of intangible products, called services. The basic contents of this industry are banking and finance, telecommunications, wholesale and retail trades, real estate/property management, general business services, hotels and restaurants, transport and storage to name only a few.

**(a) The financial services industry** - This industry is very strong with a good number of both domestic and foreign institutions participating actively. The sector is strongly supported by a sound regulatory and legal framework, providing a full range of services ranging from commercial, retail and merchant banking, through to mortgage lending, insurance, and investments.

**(b) The banking industry** - this industry competes favourably with the industries of industrialised nations with extensive nationwide electronic banking facilities with

their widespread Automatic Teller Machines (ATMs), telephone banking and fast growing Internet banking. The four major banks in the country are: the Amalgamated Banks of South Africa (ABSA- a part of Barclays Bank of England), the Standard Bank, First National Bank, and Ned Bank. These four major players hold more than 80 per cent of the total banking assets in the country (southafrica.info).

**(e) Information technology** - South Africa is a clear leader and the powerhouse of Africa's information and communications technology (ICT). The country boasts the largest and most advanced ICT system on the African continent. This industry is ranked twenty third in telecommunications development in the world and is fifth in terms of investment in the industry (Going Global Inc., 2006:24).

This sector comprises over a hundred public dial-up Internet access providers that serve nearly 650,000 dial-up subscribers. The major players in this sector include world leaders like Microsoft, Vodaphone, Dell, WorldCom, Sentech, Siemens, Alcatel, SBC Communications, Telecom Malaysia, MTN, Cell C, amongst others.

### **3.4 The links between manufacturing/secondary sector and other sectors of the economy**

The manufacturing sector of the economy is widely regarded as the propeller of the economy. This is borne out by the fact that the activities of the sector permeate the entire system of the primary, secondary, and tertiary sectors.

Manufacturing takes place when input resources like natural materials (that are supplied by the primary sector); finance, insurance, banking, inbound and outbound logistics, and after-sales services (that are provided by the tertiary sector); machines, tools and equipment, work-in-progress, buildings, furniture, and fittings (which are provided by the secondary sector itself) all work together to add value to the input resources.



Hayter (1997:12) provides a conceptual basis that justifies the links between the manufacturing sector and other sectors of the economy through his definition. He defines manufacturing as follows:

The term 'industry' refers to all the economic activities such as the mining industry, the transportation industry, the hotel industry, and the retail industry, as well as the manufacturing industry, which is sometimes referred to as a secondary industry. It is also common in the English language to interpret industry as manufacturing, while industry and manufacturing are often used as synonyms.

The author went further to describe activities that fall under 'manufacturing' as those that involve transforming raw materials or processed materials, through fabricating, assembling, processing, or through mechanical, electrical or chemical means into more valuable products. Practically, manufacturing as a process, requires input from every aspect of the entire economy.

### **3.5 Links between manufacturing and investment**

Having examined the links that exist between manufacturing and other sectors of the economy; it is also important to examine the links that exist between the manufacturing and investment activities.

Knox, Agnew and McCarthy (2003:312) highlight the significance of the manufacturing industry in any economy. They argue that the attention given by many developing countries to industry is partly as a result of the prestige of this sector, which is widely considered the hallmark of development. The recorded growth of investment in manufacturing has been influenced by the growing significance of MNEs and contractual co-operation between various enterprises in different countries (De Vroey, 1984).

The importance of MNEs in the foreign national economies of recent times cannot be overemphasised. Ball and McCulloch (1988:8) observe that foreign subsidiaries of the

MNEs have become increasingly important in the industrial and economic life of many nations. This is so because of the role played by these agents of development in both developed and developing economies. The general expectation that FDI will benefit a local economy has motivated many governments to offer attractive incentive packages to entice investors to invest in their economies (Meyer, 2004).

### **3.6 The contributions of FDI to the manufacturing sector of the economy**

Hood and Young (1979:182) quantitatively analyse and indicate the impact of FDI on the industrial/manufacturing sector of the host economy. They observe that the host country gains access to 'technology and management skills which, by definition, are not freely available locally.' They are also of the opinion that this is a result of the employees of MNEs changing jobs and thus diffusing the already acquired knowledge into the incumbent enterprise. They also indicate that the total wage income increases as a result of the increased capital available to the labour force and the increased demand for workforce - 'demand pull.'

In Sub-Saharan Africa (SSA), and specifically, South Africa, foreign organisations or investors that are partly or completely either FDIs or Joint Ventures, largely dominate the manufacturing sector (UN, 2006).

### **3.7 The contribution of manufacturing to the GDP**

As stated earlier, the manufacturing sector revolves around a wide spectrum of activities in the primary, the secondary and the tertiary sectors of the economy. Considering its widespread range, its demand on all the sectors of the economy cannot be over-emphasised.

Until about 1870, the economy of South Africa was almost entirely dominated by agriculture. Mining assumed prominence in the 19<sup>th</sup> century when minerals like gold

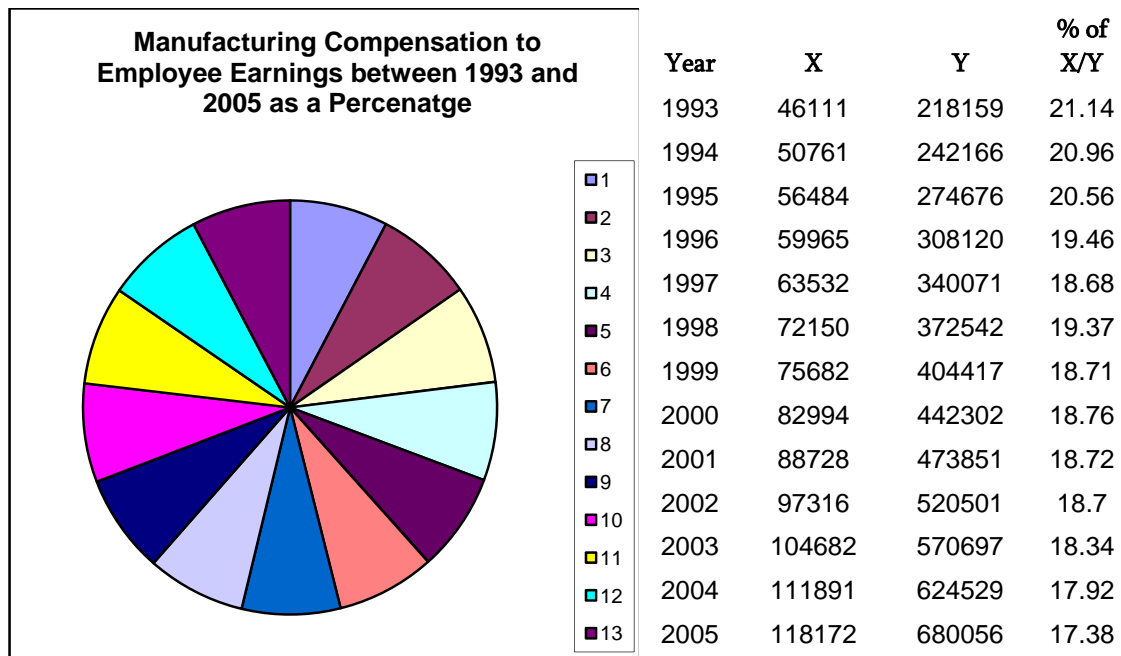
and diamonds were discovered. The political leaders' desire to diversify the economy through value-added activities began to yield dividends, as manufacturing became the largest contributor to the GDP by 1945 (Zezeza, 1993).

### **3.8 The Multiplier effects of manufacturing on employment**

Economic analysis of the recent trends indicates that the service sector is now the leading contributor to South Africa's GDP, claiming about 60 per cent in 2005, with the manufacturing sector accounting for only 35 per cent of the GDP. Expansions in the manufacturing industry and its multiplier effects on other sectors of the economy may yield a proportionate increase in the productivity of other sectors of the economy (as established in 3.6 above).

An analysis reveals that in 1993, agriculture, forestry, and fishing contributed about R5, 069 million to employee compensation; while mining and quarrying contributed R15.8million; manufacturing R46.1million; electricity, gas and water R3.9million; construction R9.6million; wholesale and retail trade, hotels, and restaurants R29.2million; and transport, storage and communication R17.8million (Statistics South Africa, 2006). By 2005, the manufacturing sector accounted for about 34.3 per cent of the total of R344, 724 million for the compensation of employees, and perhaps a far bigger percentage when its multiplier effect is considered (ibid).

**Table 3.1 and Figure 3.2: Compensation of employees at current prices between 1993 and 2005 (in Million Rand). The coloured legend in the pie chart represents years from 1(1993) through to 13 (2005)**



*Source: Self-generated from Statistics SA's GDP publications.*

**N.B:** X= Manufacturing, Y= Total Compensation; and the percentage is obtained by dividing X by Y.

The pie chart above indicates a relatively stable contribution over the period under study. As expressed earlier, the multiplier effects of the manufacturing sector relative to the overall economy is expected to reflect a higher contribution for this sector.

### 3.9 Chapter summary

This chapter examines the trend of FDI inflow to South Africa. It begins by looking at the contents of FDI flows to Southern Africa between 1994 and 2005. It interrogates the trend of foreign investment into South Africa since political emancipation in 1994 up until 2005. The major sectors of the economy, their performance and the principal investing organisations over the same period of time were also considered.

The link between manufacturing and other sectors of the economy are examined, reflecting the link between FDI and the performance of the manufacturing sector. The chapter concludes by looking at the effects of manufacturing on employment.

The following chapter (Four) will attempt to analyse the investment environment in South Africa, from pre-colonial era till 2006.

## CHAPTER FOUR

### THE DYNAMICS OF THE INVESTMENT ENVIRONMENT IN SOUTH AFRICA: A POLITICAL-ECONOMY PERSPECTIVE (from the pre-colonial era till 2006)

#### 4.1 Introduction

If one goes back in history, one discovers that long before the arrival of the Europeans, South Africa had well-established economic relations with Arabian and Asian countries. The country was prominent for its supply of a range of products, such as gold, copper, millet, grains, and coconut to the Middle East and Indian Ocean economies (Rugumamu, 2005). Just like other parts of Africa, by the beginning of the 19<sup>th</sup> century, local trade had existed for centuries in most parts of Southern Africa.

#### 4.2 A brief historical overview of investments in South Africa

The British occupied the Cape in 1806. As a result of this occupation, the Cape enjoyed a preferential tariff arrangement within the British Empire; a move that boosted its wine production, and exports to Britain and Australia. According to Ross (1983), between 1806 and 1839, the Cape generally exported between 34 per cent and 50 per cent of its total wine production. Wool exports became significant in the 1840s until the discovery of diamonds and gold, which automatically translated mining into the mainstay of the country's exports. Diamonds were first discovered in 1867 (ibid).

The mineral revolution firmly integrated South Africa into the global economic system. The country attracted the bulk of FDI on the continent and more specifically, Sub-Saharan Africa (SSA), as it attracted about 43 per cent of the EE1.2 billion currencies invested in the region between 1870 and 1936. The economic boom also spawned some of the continent's largest companies and some of the world's mining monopolies including De Beers and Anglo-American.

### **4.3 Investment strategies in South Africa**

During the 1950s and 1960s, the predominant industrial strategy adopted by developing countries was import substitution (Holden, 1990). This choice was favoured by the post-war arguments supporting pessimism regarding exports and the expected future benefits of protecting infant industries. The negative perception was that exports from the developing world were deemed inadmissible in the world market. Aside from the Gang of Four (Hong Kong, South Korea, Taiwan, and Singapore), all other developing nations, most especially South Africa, 'justifiably' encouraged industrialisation in the domestic market through comprehensive protective measures (ibid).

This vigorous encouragement of import substitution was reassessed in the 1970s with attempts to encourage production for export purposes. This move was necessitated by the saturation of the domestic market, and the resulting overcapitalisation. After the initial success, a series of economic sanctions that were imposed on South Africa from 1986 onwards, prohibiting the export of agricultural goods, coals, clothing and textiles to the United States and parts of the then EC (now the EU), jeopardised this strategy considerably. As a result, the state decided to encourage import substitution by boosting production for local consumption while simultaneously promoting exports (where possible) (Bhagwati, 1988).

### **4.4 The political economy of South Africa during the apartheid era- a brief overview**

It has been argued that good policy reforms are essentially synonymous with economic peacefulness. Although such reforms may not create a development miracle, they can avert the devastating effects that characterise bad policies (Rodrick, 1992). To achieve this, a government may seek a sound combination of both import substitution and export-incentive policies; as these will combine well with non-

tradable goods to give the economy the boost in growth it requires (Moritz, 1994). The following paragraphs will examine the attempts made to liberalise the South African economy, as a way to attract inflow investment.

Moritz (1994:11) defines trade liberalisation as “any act that would make the trade regime more neutral- nearer to a trade system free of government intervention.” However, some analysts today (Tomohara, 2004; Christmann and Taylor, 2001) agree that government intervention is a key component in the successful export-oriented countries as these governments provide the needed enabling environment and incentives to facilitate the emergence and evolution of a dynamic and competitive economic structure.

#### **4.5 Past industrial policies in South Africa**

From the mid 1920s up to the post World War II period, South Africa adopted an explicit industrial policy epitomised by import substitution (Moritz, 1994; Soludo, Ogbu, and Change, 2004). Import Substitution Industrialisation (ISI) was adopted by the apartheid regime as an instrument to avert the eventual collapse of the economy, occasioned by the global isolation.

This strategy (ISI) did initially work well for the regime as the economy transformed from the production of consumer goods to that of capital and intermediate goods; more simply, a regression from light to heavy industry. Between 1925 and 1985, manufacturing recorded a growth rate from 36.4 per cent of GDP to 64.3 per cent (Moritz 1994).

As a result of the capital-intensive manufacturing strategies of the government, between 1950 and 1970, a rise in the capital/labour ratio of nearly 75 per cent was recorded, coupled with virtually no growth rate in employment - overcapitalisation.



The adoption of capital-intensive industrialisation by the apartheid regime could be attributed to the following reasons:

- 1 The increased labour militancy within the unions, demanding higher pay and better working conditions, was deemed an attempt to increase the cost of production.
- 2 The tax system was fashioned to reduce capital costs and the cost of imported machineries; this resulted in a lower price on capital vis-à-vis labour.
- 3 Between the 1970s and the mid 1980s, real interest rates were low, and even almost negative, thereby encouraging cheap capital formation/application as input factors.

The increase in importation of machines and input capital (intermediates) increased the ratio of imports to GDP; this ratio amounted to some 25 per cent from 1925 (Moritz, 1994). Unlike other regions, most especially, Latin America, South Africa's import substituting policy only covered consumer goods and virtually excluded capital goods – the import substituting industries then formed the basis for increasing the import of capital inputs (Nattrass and Ardington, 1990).

During this period, it was reported, that the chemical industry imported more than 40 per cent of its input materials (capital and intermediate goods), the motor vehicle industry and electrical machinery imported over 34 and 30 per cent respectively (Moritz, 1994). Due to the failure of the ISI policy, the government tried to redress the financial crises (there was a large balance of payment deficit and a high deficit ratio to the GDP - mainly financed through domestic loans) by promoting exports and also to utilise the over-accumulation of capital that had resulted from ISI to produce for foreign markets.

To this end, the government introduced the General Export Incentive Scheme (GEIS) in 1990. This strategy was aimed at facilitating enough exports to reduce the prevalent trade imbalance and the worsening foreign exchange crisis, but for its contravention of the General Agreement on Tariffs and Trade (GATT) rules.

According to GATT, tax concessions and subsidies (export incentives) that discriminate in favour of particular exports were and are still not approved –even by the WTO, GATT's successor. Notwithstanding this problem, the export of capital goods (total machinery and transport equipment) rose from \$1.18 billion to \$ 2.28 billion (Moritz 1994; Hirsch, 1993).

#### **4.6 The post apartheid political economy of South Africa**

To lay a solid foundation upon which a sound post-apartheid policy analysis can be based, the following quote presents a lead:

The political transformation of South Africa will make it possible to achieve economic growth and to set realistic goals for improved living standards and economic security for all South Africans, especially the most disadvantaged. Without a new growth path to put these goals within reach, political transformation itself will be in jeopardy. What is required is effective state intervention, a vigorous private sector, and the active involvement of women and men in all spheres of society, and a carefully-designed, implementable, and well-supported macroeconomic strategy for transition (MERG, 1993:1).

On the eve of the transition to a non-racial democracy, many organisations and groups were engaged in the task of coming up with an applicable policy framework to regulate the political economy of South Africa. Prominent among the outcomes were the National Party's Normative Economic Model (NEM) and the Macroeconomic Research Group (MERG) Reports.

#### **4.7 The transition process**

The apartheid regime, no doubt, was liable to South Africa's low economic growth and poor socio-economic development. This was the result of many poor economic policies and lack of global support for a few good ones. As a result, MERG was commissioned to recommend a policy framework that is suitable to pioneer South Africa's economic recovery and growth.

The major architect of this optimism was the "Asian miracle" which emerged, and was achieved through a labour-intensive export-oriented strategy. As the debate gathered momentum with regard to the way forward, the incumbent government (the National Party), proposed a Normative Model Approach based on the Normative Economic Model (NEM). This proposal, according to analysts, did nothing but 'normalise' apartheid. This approach failed in every respect to address the inequalities created by the apartheid regime, and it was thus rejected (MERG, 1993).

The rejection of the NEM recommendation precipitated the adoption of the Macroeconomic Research Group (MERG)'s report, which was deemed more appropriate. The MERG's approach focussed attention on achieving rapid economic recovery and the much needed economic growth and development for a sustainable social delivery system.

Based on its relevance to this study, the MERG approach and its recommendations will be evaluated, being the major springboard upon which the policy framework of the 'new' democracy was purportedly based.

#### **4.8 The MERG's recommendations**

The MERG policy recommendations for the government of national unity (GNU) began with tax reforms, due to its considered importance for the government, the people and investors.

As a part of the transformation efforts, an equitable tax system that is considered efficient was seen as desirable. To this effect, a range of complementary taxes was recommended to place all citizens in the tax net in a progressive manner (MERG, 1993). This implied the introduction of a tax system that implements a broad structure of complementary taxes. This policy also has the advantage of spreading tax revenue to absorb likely shocks from one tax base, which may cause instability in the tax system if not controlled.

According to MERG, it is suggested that the main focus of company income tax (profits tax) should address the following:

1. Investment incentives - which should be expanded and focussed. Accelerated depreciation is necessary; carryover tax credits should encourage investment ventures with low initial profits; training and skills development should be encouraged through corporate tax-cuts.
2. Tax floor and transitional corporations.
3. Mineral taxation

Other fiscal policies (taxes) should include the Value Added Tax (VAT), custom duties, excise taxes, capital transfer tax, wealth taxes, tax on fixed property and other taxes, which include stamp duties, securities tax, financial transactions tax, turnover tax, employment/wage bill tax - that are mainly directed at taxing the movement of financial assets through the financial system.

To achieve this, MERG proposed the establishment of an “Independent Fiscal Commission” that will be composed of independent fiscal experts and specialists from business, labour, civil society, and government.

#### **4.9 Other policy recommendations by MERG**

Based on the model analyses of its various research projects, MERG prepared some fiscal and monetary reforms to guide the economy in the direction of recovery, growth, and development. Notable among the macroeconomic policy reforms recommended by the Group were the following:

##### **4.9.1 The exchange rate policy**

The exchange rate policy was directed towards three focal objectives namely: balance of payments stability, internal stability (either the control of inflation or employment considerations), and microeconomic efficiency.

- The exchange rate regime- The prevailing exchange rate regime was characterised by instability. During the period between 1979 and 1983, the recommendations of the de Kock Commission were adopted – a policy of variable dollar pegging, which necessitated the Reserve Bank to announce the exchange rate each day.

Although, this policy ended in 1983 to facilitate a foreign exchange deregulated era, persistent government interventions continued to cause further instability in the exchange rate markets. This amongst others had an unsettling effect on sceptical investors.

To allay this fear, MERG proposed the adoption of a really effective exchange rate administered by the Reserve Bank. This proposal suggests that a target zone approach be adopted, whereby the real exchange rate is kept within a

band around a central rate – a flexible process that allows for inevitable volatility caused by economic swings.

- Controls of capital movement – to resolve a series of restrictions placed on capital movement, and also to safeguard possible capital flight, MERG proposed broadening and increasing the efficiency of the foreign exchange market. The Group supported the general argument that exchange controls are a deterrent to foreign investment, but was of the opinion that it is the nature of the controls, rather than their existence, that deter the inflow and sustainability of FDI.
- Foreign capital inflow - the resultant isolation, boycotts and sanctions from the apartheid era placed South Africa in a very difficult financial position. The country failed to attract the finance from abroad that was needed for its necessary growth and development projects, given that there was a poor record of domestic savings.

This, along with the maladministration of funds, contributed to plunging the country into an unhealthy state of foreign borrowing, which was estimated to be at R52.8 billion at the end of 1992. Although, the new democratic government was expected to attract funds from institutional lenders like the IMF and the World Bank, MERG advised limiting the degree of reliance on direct borrowing, partly as a result of the bitter experiences of the 1980s (the debt crisis that arose as a result of the accumulated maturity of short-term loans). In addition, it cautioned against borrowing as a result of the danger of repayment (*e.g. the Asian currency crises of the 1990s*).

## 4.9.2 The monetary policy

The monetary policy centres on two major concerns namely, the role of interest rates and control of inflation.

- The role of interest rates – in any economy, the cost of capital/finance (interest rate) is always a cause for concern. Its importance lies in-between using it as a tool to regulate inflation by raising its rate to discourage consumption (credits) or by lowering its rate to increase consumption. Whichever measure is applied may either result in inflation or may defeat the purpose of expanding the market capacity (Michie and Padayachee, 1998).

As a direct intervention mechanism in the economy by the Reserve Bank, its choice of interest rates affects the general level of spending in the economy. There is always the concern regarding whether or not the anti-inflation policy is in conflict with growth, employment, and other poverty alleviation objectives (Van Seventer and Gibson, 1995). For example, the de Kock Commission recommended an increase in both the REPO rate (the price at which the Reserve Bank lends to the commercial banks) as well as the prime rate (the price at which the commercial banks lend to customers).

By January 1985, the prime overdraft rate was raised to 25 per cent, and the real interest rate to prime borrowers was at 13 per cent. This resulted in an immediate economic recession that necessitated readjustments of the interest rates by 1986. As this happened, inflation started picking up again. Riding on this experience, MERG observed that the monetary policy of the new democratic government should show some sensitivity to the state of the real economy – a state of severe economic recession and extremely high rates of

unemployment. This situation required low interest rates; the MERG model recommended a positive long-term interest rate of 2 per cent.

Aside the fiscal and monetary policy reforms recommended by the MERG, the group also proposed some crucial poverty alleviation approaches aimed at addressing the societal divides of the past. These are aimed at bringing about a new democratic environment that offers the friendliness required to attract FDI.

#### **4.9.3 Investment policy**

Trade policies under the apartheid regime were characterised by uncertainty, complexity, and special interests. The policies were highly volatile as they responded spontaneously to the bigoted interests of a few powerful investors. Statistics indicate that there were over 12,000 tariff lines, and hundreds of tariff settings and numerous other duties designed to bolster the protectionist trade policies of the regime (MERG, 1993: 233). The group recommended the following, amongst others:

- Restructuring of the investment system - Having observed that the South African manufacturing industry has the potential to boost exports competitively, it was suggested that a policy commitment was necessary to improve the investment environment, skills and training, and developmental support to smaller enterprises.

According to MERG, a good investment environment is created through liberalisation, lowering of tariffs and non-tariff barriers to conform to GATT minimum requirements, a continued support for high value-added exports, and implementation of a workable anti-dumping system. This reform should also include the adoption of a well-structured fiscal programme that is aimed



at developing the domestic productive sector - by increasing investment in social and physical infrastructure.

Promoting investment - promotion of both direct and indirect foreign investments should be encouraged especially those that could improve South Africa's technological capacity and access to new export markets.

#### **4.9.4 Restructuring the financial institutions**

To achieve a growing economy aimed at addressing unemployment, inflation, income and wealth redistribution as well as economic empowerment in the long run, it was considered necessary to establish new types of financial institutions and to carry out effective changes to the existing system to enable a kind of responsiveness that would provide the necessary support for the anticipated economic reforms.

From the standpoint of the existing related policies, a glaring failure was evident in the delivery pattern and administrative structures. Prominent among these were the dominating four large commercial banks, two big life insurance companies, and the pension funds. These institutions failed to channel their focus to increasing personal savings of the vast majority of people, especially the low income group.

MERG's recommended policy reforms are as follows:

- The establishment of a people's bank – the group recognised the need for a generally affordable banking system for the majority of the population, irrespective of the geographical divide or economic placement. This, according to the Group, could be achieved through the establishment of a People's Bank, a semblance of Europeans and Japanese giro banks.

This measure is expected to help ameliorate the problems that characterised the then banking system like the black population's apathy regarding "a white-man's bank," accessibility, the lack of proper understanding of banking terms and terminology, and the lack of simple understanding and interpretation of the numeracy involved in banking transactions.

The Group projected a boom in the disposable income of the vast majority of the people, most especially the disadvantaged black population (as a result of increase in income and a rise in gainful employment). It was envisaged that the boom will lead to an unsustainable boom in consumption, and thus exacerbate the balance of payment situation.

As a result, the sustainability of the income redistribution goal of the democratic movement could possibly be realised if the new financial gains that accrue to the poor people were committed to savings, or the acquisition of investment assets rather than immediate consumption.

- Interest rates - on the issue of interest rates, the group argued that a floating rate that conforms to the monetary and exchange rate targets should be adopted. Some specific savings instruments and personal credit as well, were deemed necessary to be regulated through policy reforms. The Group observed that the country would be subjected to a series of high financial/banking risks during the period of transformation and beyond, if the Reserve Bank continued to have little control over financial institutions and banks.

#### **4.10 The political economy of South Africa since 1994**

South Africa held its first-ever non-racial national and provincial elections on April 26-29, 1994. On May 19 1994, Nelson Mandela became the first black president under the umbrella of the Government of National Unity (GNU). He was the head of a

cabinet that included representatives of the African National Congress (ANC), Inkatha Freedom Party (IFP), and the National Party (NP).

Owing to poor investment perceptions created by the defunct apartheid regime, it was incumbent upon the democratic government to carry out some policy reforms in order to improve the investment environment of the country required to attract the needed inflow FDI.

The transition to civil rule in South Africa facilitated the country's readmission into numerous global institutions and organisations, especially, the GATT (now WTO). To benefit from international investment, South Africa launched the process to ensure its integration into the global economy.

#### **4.11 The early stages of democracy (1994-1996)**

The general consensus among the political leaders and other stakeholders at the beginning of democratic rule appeared to have supported the arsenal of the ANC's most envisioned Reconstruction and Development Programme (RDP); a policy framework designed to serve as the economic lodestar (Michie and Padayachee, 1998).

The preface to the RDP document was encouraging. It represented a view to making a positive change in all aspects of society:

*It (the RDP document) represents a framework that is coherent, viable and has widespread support. The RDP was not drawn up by experts – although many, many experts have participated in that process – but by the very people that will be part of its implementation. It is a product of consultation, debate, and reflection on what we need and what is possible (Mandela, 1994).*

## 4.12 A critical review of the RDP programme

Section 1.1.1 of the document defines the course and content of the RDP as well as the strategic interests of the leadership as follows:

RDP is an integrated, coherent socio-economic policy framework. It seeks to mobilise all our people and our country's resources towards the final eradication of apartheid and the building of a democratic, non-racial and non-sexist future.

This vision statement appears to imply a desire to address the economic problems of the past, that were characterised by the unproductive sectional application of state resources, endemic corruption, social and economic oppression, inequalities, and low inflow FDI, all of which resulted in a low growth rate.

As a backdrop to the new regime, the framework comprised six basic principles (section 1.3.2-1.3.7) summarised in section 1.3.8 as follows: “An **integrated programme**, based on the needs of the **people**, that **provides peace and security for all** and **builds the nation, links reconstruction and development** and **deepens democracy** – These are the six basic principles of the RDP.”

There are many proposals, strategies and policy programmes that combined to form the RDP policy framework. These are grouped into five major policy programmes namely:

- meeting basic needs;
- developing our human resources;
- building the economy;
- democratising the state and society, and
- implementing the RDP.

These programmes were intended to address poverty and deprivation that was rife in society, most especially among the rural dwellers (an estimated seventeen million people were surviving below the Minimum Living Level at the time, while more than eleven million lived in rural areas). It was hoped that addressing the basic needs of people at grassroots level would help create a peaceful and stable society, needed to attract FDI.

Chapter three of the policy framework addresses the issue of human resources development exhaustively. The vision and objectives of this programme were meant to achieve, amongst others, the provision of opportunities for people to develop themselves in order to improve the quality of their own lives and the standard of living of their communities. These were expected channels to increasing the purchasing power of people, thereby creating lucrative investment communities across the nation. If achieved, this would lead to a democratic society with a growing economy.

Chapter four addresses the issue of building the economy. Section 1.4.12 identifies mining, manufacturing, agriculture, commerce, financial services and infrastructure as constituting the strength of the economy; while the excess capacity of electricity generation was identified as an opportunity to address the problem of energy for both industrial and domestic uses. This chapter also contains how the government intends to combat over-investment in capital factors. It also mentioned capital flight that resulted in a serious capital account deficit in the past and how to prevent its recurrence.

The document acknowledges that the South African economy was in a deep-seated structural crisis that required fundamental reconstruction. The economy was also observed to have remained dependent on mineral exports, while the manufacturing

sector failed to create jobs, meet the basic needs of the majority or compete favourably on world markets (section 4.1.1- 4).

To address these and other related problems, the vision and objectives statement indicate that reconstruction and development will be achieved through the leading and enabling role of the state, a thriving private sector, and active involvement by all sectors of civil society. This is aimed at achieving sustainable growth in the long run. To achieve this, it aims to establish a dynamic, integrated economy able to provide higher incomes, reduce excessive dependence on imports, and compete on foreign markets (section 4.2.1-.2 & 4.2.8).

The underlying philosophy of the policy document regarding industry, trade, and commerce is expressed in section 4.4.2, though, not in much detail. The opening section of the chapter (section 4.4.1) indicates that the economy requires coordinated and effective policies that merge private sector initiatives and government support to address its structural weaknesses.

It also acknowledges that coherent strategies are required in industry, trade, and commerce to meet the challenges of a changing world economy, while at the same time meeting the needs of the majority of people. The policy envisages a five per cent growth rate and the creation of 300,000 to 500,000 non-agricultural jobs per annum within five years of its implementation.

It is hoped that through private-public partnership, the needed incentives could be generated to boost exports in manufacture. This is expected to increase foreign earnings, stabilise economic growth and development, and subsequently improve the standard of living for the majority, as the market capacity is enlarged.

The policy introduces instruments to promote exports of manufactured goods. The industrial policy aims at ensuring good support for and strengthening those industries that have been internationally competitive – as a way to creating better linkages with other sectors, to boost capacity utilisation. Moreover, the policy looks to strengthening economic and political ties with the SACU, SADC, the rest of Africa, Europe, the United States, and the rest of the world.

In addition, the democratic government recognises the need for creating stable, consistent and predictable macroeconomic policies, as well as a dynamic economy necessary for creating a climate conducive to foreign investment (section 4.4.4).

It is also deemed necessary by the government to intervene in restructuring the ownership, control, and functionality of the mining industry (section 4.5.1.1). To do this, the government intends to consider ways and means to encourage small-scale black mining enterprises and enhance opportunities for participating in this industry through support, including financial, and technical aid and access to mineral rights (section 4.5.1.14).

Agriculture is also seen to be important, as it constituted five per cent of the GDP and over ten per cent of employment opportunities (section 4.5.2.1). Given the importance of agriculture, the government aims to create a restructured agricultural sector that spreads the ownership base, which encourages small-scale agriculture, develops the commercial sector further and also increases production and employment (section 4.5.2.2). Fishing and tourism were also given considerations similar to agriculture.

Section 4.7 deals with the reform of the financial sector. According to the document, conglomerates centralised all the assets of the financial sector, neglecting the needs of the rural dwellers. To redress these shortcomings, the document provides for a review

of both regulations and a regulatory system to bring about greater efficiency in the mobilisation and subsequent allocation of savings. The intervention here requires establishing smoothly functioning and inexpensive payment systems that assure safety of consumer deposits (Section 4.7.2).

Having adequately identified problem areas and the need to effect the necessary reforms, the question that arose was how to finance the identified structural reforms and most needed economic growth and development.

In Section 6.5, the issue of finance is raised. To generate the needed resources to finance the policy focus, efforts were directed towards harnessing the under-utilised resources of the democratic government, the private sector, labour communities, and women, and by utilising these resources in a rational and effective way. More precisely, the largest portions of all RDP proposals were expected to be financed by better use of 'existing' resources.

Section 6.5.12 provides for a restrictive tax system in order to make it more equitable, fair, and just; and to reduce the burden caused by fiscal drag on the middle-income people. It is also aimed at eliminating bias against small and medium-sized enterprises, and company tax breaks for health, education, housing, and other expenditure that may militate against attracting foreign investment.

Some inherent deficiencies in the RDP resulted in the formulation of a 'complementary' policy, namely GEAR in 1996. The GEAR policy framework was aimed at redressing the loopholes in the RDP.



#### **4.13 Growth, Employment and Redistribution (GEAR) - 1996-2006**

The RDP failed to deliver the expected rapid economic recovery, more because of the privatisation policy that forms the bedrock of the RDP programme. As a result, there was the need for a rethink of strategy.

To redress the shortcoming in the RDP, the GEAR policy framework was chosen amongst various policy options presented to the government. The policy was seen as a strategy for building and restructuring the economy. It was described as an integrated economic strategy that can successfully confront the related challenges of meeting the prevailing socio-economic challenges (GEAR's introduction, section 1, paragraph 2).

Contrary to the early approach that the researcher employed in evaluating MERG's policy recommendations and the RDP policy framework, the approach to the GEAR evaluation will be different for the following reasons:

- (1) GEAR is a policy framework designed towards "implementing the RDP in all its facets." As such, it is considered a complementary framework to mainly (or only) solving the inherent weaknesses in the RDP. To this end, it is essential to only focus on the addendums to the RDP document.
- (2) The policy document contains numerous contradictions (as will be seen later).
- (3) Despite its most acclaimed ability to create an investment enabling environment, it appears to have exacerbated the situation. It is thus considered logical to interrogate the provisions of the document in line with the contributions of the available literature.

It has been argued that a stable socio-political environment characterised by high purchasing power and living standards are the most favourable factors that influence foreign investors' choice of locating a long-term business interest (Nattrass, 1996;

Schimulow and Greyling, 1996; MERG, 1993; Michie and Padayachee 1998; and GEAR (itself), 1996:16-section 7, 3<sup>rd</sup> paragraph). GEAR ignored this principle.

Having stated earlier (in the introduction) that GEAR is designed for the purpose of achieving the RDP, a series of contradictions in the document undermines this purpose. For instance, GEAR proposed to attain a growth rate of six per cent per annum and create 400,000 jobs per annum by the end of 2000 (section 1.3, paragraph 2), which was considered lower than the RDP's projection.

In the same paragraph, rather than focusing on the more inward-looking economic reforms that characterise the RDP, GEAR appears to focus more on meeting the demands of international competitiveness – an outward-looking approach.

As stated in the appendix 4 of the GEAR document, the key growth drivers were identified to be investment and exports. Experience from the apartheid era taught that promoting manufacturing exports without a corresponding increase in intermediate and capital goods would exert pressure on trade balances and the balance of payments - with a possible consequence of a capital account deficit. If this occurs, it will trigger off fiscal and monetary instability.

Moreover, evidence from developed countries indicates that, “a much higher percentage of production is geared towards domestic use, consumption and investment. For example, the USA and Japan's share of exports of their total output was only eight and ten per cent on average between 1960 and 1994 respectively” (Adelzadeh, 1996:71).

According to the same author, at that time when exports were categorised as a growth driver in South Africa, one-fifth of the country's output was exported. More precisely, within that period, South Africa's non-gold export-GDP ratio was equal to 21 per

cent. When the export of gold is included, the figure rose to more than 25 per cent to GDP – which was far higher than the figure for the OECD countries (Adelzadeh, 1996:71).

The following table (4.1) indicates MERG’s proposed sources of growth based on the Group’s simulation:

**Table 4.1: Sources of growth for the MERG strategy (average percentage contribution to GDP growth)**

Year	1994-99	2000-4
Private general consumption expenditure (excluding private education, health and rent expenditures)	0.4	2.2
Social infrastructure expenditures (private and public health and education expenditure)	0.7	0.8
Physical infrastructure expenditures (general government investment, housing and utility industry investment)	1.1	0.4
Other (mainly private) fixed investment	0.7	1.7
Inventory investment	0.2	0.2
International trade	-0.8	-1.3
Other (e.g. rent government administration / defence, etc.)	1.0	0.7
Total GDP ( <i>summation of all the projections</i> )	3.3	4.5

*Source: MERG Simulation (MERG Report, 1993:18)*

From table 4.1, it can be seen that growth was projected to increase at a rate of 3.3 between 1994 and 1999; with government spending on infrastructure contributing the highest share (1.1 per cent). The projected growth rate of 4.5 between 2000 and 2004 was based on the assumption that domestic consumption will contribute 2.2 per cent of the GDP growth while the private investment will add 1.7 per cent. This situation is observed to be quite similar to the current economic situation, but supported with different mechanisms.

On page three (under critical considerations: A framework for growth), the document refers to the “structural adjustment under terms set by international agencies” and an

abrupt curtailment of growth if exchange rate instability occurs (or reoccurs). Since 1996, records have not shown any persistent exchange rate instability. In fact, South Africa had been characterised by “macroeconomic stability’ since 1996 until this period (Weeks, 1999:797). Since there had not been exchange rate instability or macroeconomic crises, the need to adopt tight budgetary measures was unclear.

The document states that government consumption expenditure would be cut back, private and public sector wage increases kept in check, while tariff reforms would be accelerated to compensate for any depreciation and, domestic savings performance would be improved. These measures are aimed at counteracting the inflationary impact of the exchange rate adjustment, permitting fiscal deficit targets to be reached, establishing a climate for continued investor confidence and facilitating the financing of both private sector investment and accelerated development expenditure (section 2.3, paragraph 2). In short, this may be interpreted as the summary of the entire policy document. It is a clear indication that the RDP has been abandoned, and a new policy direction has been embarked upon.

This summary of GEAR as a macroeconomic initiative could well match a set of statements and recommendations made by the apartheid State on the eve of the transition to democracy, and which took the form of the Normative Economic Model (NEM), initiated by South African businessmen under the auspices of the South African Foundation (SAF), and the agency of the Washington Consensus: the International Monetary Fund (IMF) and the World Bank.

The Neo-liberal approach recommended and supported (successfully) by these groups widely negates the provisions of the ANC’s earlier Keynesian paradigm that targeted achieving a rapid growth rate and development through reconstruction and

redistribution. A rapid shift away from this earlier focal point signifies a shift in direction towards the Washington Consensus (Michie and Padayachee 1998).

Section 2.2 (paragraph 3) indicates that the government will take further steps in the gradual relaxation of exchange control while it continues with inflation reduction and exchange rate management measures. The motive behind the need to relax exchange control is unclear because it may create the opportunity for a possible capital flight by allowing residents to abscond with domestic capital that may (and usually does) result in a foreign exchange crisis. Also, reducing government spending as an antidote to curtail inflation may conscript economic growth, thereby defeating the aspirations of attracting foreign investment.

The calculation was that about 93 per cent of the total stimulus expected to achieve the rate of GDP growth (4.2 per cent in 1996-2000) was to be generated by private investors (Weeks, 1999; Adelzadeh, 1996). In such an event, it is logical to conclude that the success of GEAR principally depends on the immediate success of government to stimulate private investment (most especially, foreign investment). In addition, it was thought that the investors would respond positively to the call of investing in South Africa and that they would welcome the incentives created for investing in South Africa. The disappointment in realising this projection dealt a blow to the GEAR policy framework, and ultimately, its disapproval.

Not surprising, it is observed that the policy has failed to deliver in key areas since its introduction in 1996. Formal employment continued to decline and the desperately needed FDI also remained elusive, and consequently, the ambitious economic growth targets were never realised. Growth slumped to 0.8 per cent and later grew at an even slower pace by dropping to 0.5 per cent in 1998 (Wikipedia, 2007).

While many factors might have influenced the performance of the economy during these periods, there is a *prima facie* case that the GEAR policy package made a significant contribution to the collapse of growth in South Africa. This was as a result of its emphasis on deficit reduction (Weeks, 1999). Numerous researchers and economists (such as MERG 1993; Standing, Sender and Weeks, 1996; Van Seventer and Gibson, 1995; COSATU, 1996 and Samson, 1997) supported this viewpoint and predicted this unfortunate outcome as early as 1995 when government announced a shift towards an orthodox fiscal policy.

The argument for reducing the fiscal deficit, which was predicted to reduce real interest rates also failed. GEAR was successful at keeping inflation in check (up until 2007, when the inflation rates broke the upper boundary of 6 per cent), but it has largely failed to stimulate low interest rates.

Section 3, on fiscal policy (page 7) indicates that the fiscal deficits of 1992/93 that stood at 7.9 per cent of the GDP were unsustainable. This may not be true. The World Bank recommended that a twelve per cent fiscal deficit ratio to GDP was still appropriate and sustainable for South Africa because the higher growth pattern projected would gradually generate more public savings (as effective demand increases) so that by the year 2000, the country would experience a fiscal surplus (Michie and Padayachee, 1998).

Adelzadeh (1996) argues that not only is the analytical and empirical applicability of this argument questionable but that it also overlooks the recent international resurgence of focus on the role that public productive expenditures on infrastructure (such as investment on roads, transportation, and housing) and social services (such as education, healthcare, and welfare) play in promoting a country's economic well-being and growth. The argument goes further to say that increased public spending

on infrastructure also encourages private investment. This is in line with MERG's simulation (table 4.1 above).

The proposed reduction in government spending on infrastructure was criticised for short-sightedness. Social spending and its cyclic effect that is capable of boosting economic growth and development, thereby reducing poverty and inequality, should have been encouraged (Nattrass, 2001). Michie and Padayachee (1998) also argue that there are potential productivity and efficiency gains from a better-fed, healthier, more educated, literate and skilled labour force.

The third paragraph focuses on the justification to adopt a tight budgetary system-budgetary austerity (an element of the Washington Consensus) - to avert economic crises. GEAR has generally been credited with outstanding success in reducing the budget deficit ratio to GDP and maintaining moderate inflation, aimed at creating investor-friendly conditions (as greater stability is being injected into the macroeconomic environment).

However, many authors (as cited earlier) had predicted that GEAR would fail dismally owing to the fact that a restrictive fiscal stance withdraws demand from the economy, which dampens investment demand. In addition, owing to the fact that it is only a stable, but growing economy that is likely to attract high and sustainable levels of investment, GEAR could be justifiably regarded as an inappropriate policy characterised by wrong timing.

In the third paragraph of section 4.1, it is acknowledged that, despite the tight budgetary regime, interest rates remain high and that this does hamper the development of the small business sector, which is dependent on bank credit. More importantly, it impacts directly on the RDP as home ownership has become unaffordable for most people. How can one ethically justify such a contradiction?

Perhaps this has made Magubane (2004:663) to observe that ‘politics is a notoriously tricky and ambiguous business’.

The fourth paragraph predicts that the long-term inflow capital; especially direct investment will follow if financial stability and the reduction of inflation are achieved. According to Magubane (2004) the inflow FDI that results from the GEAR programme has been exceedingly disappointing. Natrass (2001) critically stresses that GEAR has caused job losses instead of creating them.

Despite the fact that the policies pursued under GEAR were friendly to investors, the policies did little to encourage investors other than portfolio investors (like the investment by Barclays Bank in ABSA, and the Industrial & Commercial Bank of China (ICBC) 20 per cent stake in the Standard Bank). The hoped-for increase in FDI, mostly the greenfield type, remained elusive. A few FDIs that were received were in the form of mergers and acquisitions, which tend to downsize rather than the greenfield type that provides jobs (UNCTAD, 2006).

The exchange liberalisation even led to financial crises between 1996-1998 as capital outflows surpassed inflows; necessitating the Reserve Bank to raise its real interest rates to the unforeseeable seventeen per cent. This may perhaps prompt one to conclude that, virtually all of GEAR’s targets were unfortunately missed. Moreover, the most needed integration between the manufacturing industries and small/medium-sized business appears to be ignored. The subsequent “industrial support measures” listed policies similar to those that had failed so conspicuously in the past under the apartheid regime (Adelzadeh, 1996).

Section six deals with industrial policies, but it only identified the problem areas without any policy intervention or specific investment roadmap. Considering the government’s desire to attract foreign investors, the absence of any blueprint on



trade, industrial or small-enterprise policies makes it difficult for investors to commit themselves to the South African economy (Michie and Padayachee, 1998).

According to Moritz (1994:49), “The primary aim of industrial and trade policies must be to encourage productivity and economic growth, thereby making it possible to mobilise the resources available for redistribution.” If this is achieved, poverty levels will reduce and the incidence of aggravated crime may also decrease thereby improving the attractiveness of the country as an investment location.

The last section on policy coordination – paragraph 2 - indicates that the higher growth path envisaged, depends in part on attracting foreign direct investment, but also requires a higher level of domestic savings. To bring about both FDI and increased domestic savings, GEAR signifies that the following course should inevitably be adopted: “Greater industrial competitiveness, a tighter fiscal stance, the moderation of wage increases, accelerated public investment, efficient service delivery, and a major expansion of private investment.” It appears that this section is ambiguous, because it may be impossible to achieve an increase in domestic savings in the face of a tighter fiscal stance and moderation of wage increases.

#### **4.14 The Accelerated and Shared Growth Initiative of South Africa (ASGISA)**

Before concluding the policy frameworks of the ANC-led government, a brief reference to the media briefing of the Deputy President Phumzile Mlambo-Ngouka on 6 February 2006 is considered necessary.

About a decade after GEAR was launched, the speech of the deputy president gave birth to another acronym in the form of ASGISA- (The Accelerated and Shared Growth Initiative of South Africa), which appears to be nothing different from GEAR. Commenting on ASGISA, Bell (2006:1), observes “the more things change, the more they stay the same”. It appears that the main focus of ASGISA centres on the

2010 FIFA World Cup that requires “improving/building the 10 stadiums to be used and investment in the environs and access to the stadiums” (page 5).

It appears that, ASGISA is a well-articulated embellishment of GEAR, but with the focus directed at increased spending on infrastructure until 2014, which was considered necessary to provide the necessary amenities for the ‘impressive’ hosting of the FIFA World Cup in 2010. The policy intervention also aims at halving poverty and unemployment by 2014, through capacity building and empowerment initiatives.

The NedBank chief economist Edward Osborne, was quoted by *Business Report* (February 9, 2006) where he refers to ASGISA as “a cascade of impossibilities,” probably because of the controversial platform on which the two consecutive policy frameworks (GEAR and ASGISA) are based – a desire to achieve social democratic goals within a neoliberal macroeconomic system.

#### **4.15 Policy retrospectivity**

Based on a series of arguments and evaluations of different authors presented earlier, it is observed that the main purpose of the RDP was to create a platform for redressing the gross inequalities, poverty and economic recession bequeathed to the country by the apartheid regime; as a way of achieving economic growth through inflow FDI. But the policy focus of the ANC-led alliance appears to have shifted away to a neoliberal approach that conforms to the global economic prescriptions as expressed in the Washington Consensus (Magubane, 2002).

#### **4.16 Chapter summary**

This chapter analyses the trends in investment policy in South Africa from the 1790s up till the 2006. It also critically analyses the aspects of the MERG recommendations that relates to the macroeconomic policy foci of the new government, the RDP, the

GEAR and ASGISA. This was intended to evaluate chronologically, the dynamics of the political economy of South Africa as it relates to the investment policy direction of the democratic government. It should be noted however, that the MERG recommendations played a pivotal role in the crystallisation of the investment policy direction for the GNU, and the ANC-led alliance that presently leads this country.

# CHAPTER FIVE

## RESEARCH METHODOLOGY

### 5.1 Introduction

The previous chapter dealt with the critical analysis of South Africa's macroeconomic policies as they affect the creation of an enabling environment for attracting FDI into the country.

To arrive at a reliable conclusion on whether or not investment related policies potentially affect the inflow and retention of FDI in South Africa, the need for empirical research became inevitable.

This chapter details the methodology applied in gathering and analysing the empirical information pertaining to the relationship that exists between attracting and retaining FDI, and the role played by a country's political economy. This study specifically focuses on this aspect pertaining to South Africa.

To achieve a logical analysis, this chapter will be sub-divided and categorised under the following headings:

1. Population and sampling ;
2. Description of the population and sampling;
3. Research design;
4. Pilot study;
5. Types and sources of data;
6. Data analysis and processing;
7. The Likert scale;
8. Concerns for reliability and validity; and
9. Chapter summary.

## **5.2 Research design**

Miller (2007:30) defines research design as “the plan and structure of investigation”. According to Miller, research design is “the way in which studies are put together”. Babbie (2004) defines research design as the process of focussing the researcher’s perspective for the purposes of a particular study. The focus of this research is to test the relationship between FDI inflows to South Africa and the effects of policy frameworks that govern/regulate FDI in South Africa.

A test of Exact significance level of the interaction between the dependent (inflows FDI) and the independent (policy framework) variables is deemed appropriate since the research intends to generate a relationship between the systematic changes in the value of one variable as it is accompanied by systematic changes in the other, that is, to examine the extent to which differences in inflow FDI is policy dependent.

## **5.3 Population and sampling**

The population groups targeted in this research are divided into two categories namely, the foreign investors and the policy makers (see appendices 3 and 4). These will be discussed in detail below.

### **5.3.1 Description of the population and sampling**

According to Keller (2005), a population is regarded as a group of all the items that is of interest to a statistics practitioner. This is specifically regarded as a statistics parameter upon which a valid judgement could be made. Babbie (2004) sees a population as the group (usually of people) about whom we want to draw reliable conclusions. In this research, the populations covered are the foreign investors as defined in (Section 1.3) and the policy makers (as described in sections 1.9 and 1.12).

A sample on the other hand refers to a set of individuals selected from an identified population with the intent of generalising the findings to the entire population (Gravetter and Wallnau, 2007). A sample is drawn as a result of constraints that make it difficult to cover the entire research population (e.g. finance, time).

Hassan (1995) identifies two types of sampling namely, the probability sampling (random sampling, systematic sampling, stratified sampling, and cluster sampling) and the non probability sampling (quota sampling, convenient sampling/chunk, purposive sampling and accidental sampling). According to him (Hassan, *ibid*), while the probability sampling allows for a known probability of each unit or individual population elements being included in the sample, the non-probability sampling selects the units or individuals as a result of conscious selection by the researcher (eliminating the game of chance), while targeting the entire group.

For the purpose of this research, the researcher adopted a random sampling method, owing to constraints of time and finance. The random sampling ensures the probability that every member in the population have an equal probability of being included in the sample; thereby making it possible to generalise the findings to the entire population.

Relevant information about the investors, that is, the business names, the contact addresses, the contact persons (mainly the top management level officials), and sector of participation, were obtained from the Commercial Intelligence Service (CSI), a division of Business Monitor International 2004 edition that centres on foreign enterprises in South Africa. No sector/industry was excluded from the survey.

The policy makers who were identified through appointed facilitators, were employees of either the national or provincial government, or their associated organs.

The identified facilitators at some of these parastatals refused to participate in the study. This type of response narrowed the number of participants down to thirteen.

The bureaucracies in these parastatals precipitate the appointment of a facilitator by the researcher, as it was very difficult for the researcher to administer the questionnaires directly in these offices. Also, using a senior officer in the parastatals was considered the best option considering the level of authority that seniority carries in these establishments. These assumptions proved correct during the field surveys.

### **5.3.2 Research population**

The total population for this research was identified to be about 800, according to the Commercial Intelligence Service (CIS), 2004 edition. Although, the DTI reports showed a lesser figure (about 380), but the CIS figure was taken as a port of departure, in order to ensure adequate representation.

### **5.3.3 Population screening**

A screening exercise conducted to ascertain the authenticity of the information supplied by the CIS indicated that some of the listed organisations in the publication were purely South African firms, without any foreign affiliation (e.g. Barloworld, Adcock). Also, double counting was discovered as the subsidiaries of the main organisations were also listed separately (for instance, some organisations like the Aon Group have as many as nine subsidiaries that were all listed by the publication, Chubb Security has five).

Moreover, more than 350 of the contact addresses of foreign investors published by the CIS were no longer in use. The letters of introduction (see appendix 2) that were sent to these addresses failed to deliver (the letters bounced back). This eventually narrowed the population size down to about 250.

### **5.3.4 Sample size**

Between 13 February and 30 March (7 weeks), a total of 55 questionnaires were sent out to the randomly selected investors, amongst the total population. The sample size was generated through a computer-based random selection procedure.

### **5.3.5 Response**

Out of the 55 questionnaires that were sent out within this period, 22 were returned fully completed by 30 March 2007. This represents a response rate of 40 per cent. Based on the central limit theorem, any sample that contains a minimum of 30 responses is considered reliable (Taylor, 2000:73). A series of attempts were made to increase the response rate within the targeted window period, but to no avail (see appendix 5). A further attempt to improve the response rate was constrained by the limited timeframe for this research, as well as by financial limitations.

As for the policy makers, a total of 13 questionnaires were sent to the identified government parastatals (both national and provincial) between February 26 and March 9 (a period of 2 weeks). Out of the 13 questionnaires sent to this target group, 6 were returned fully completed by 30 March 2007, the appointed date for final collection. This represents a response rate of about 46 per cent. Also, further attempts were made to improve the response rate, but to no avail (see appendix 5).

## **5.4 Pilot study**

The two sets of empirical researches were preceded by a pilot study. Leedy and Ormrod (2005) point out that, giving the questionnaires to at least six friends or colleagues will help to test the logical presentation of the questionnaire as well as its easy understanding. In this way, the pre-test will shed lights on areas that need to be adapted to improve the quality of the instrument. Miller (2007) also shares the same



sentiment as he describes pilot study as conducting a preliminary testing and practising before beginning the proper field survey/experiment.

Consistent with these perspectives, a pilot study was conducted within the first week of February (between 2 and 8 February) mainly in Pretoria. The study involved ten people. The pre-test group included three academic colleagues, four business proprietors, and three undergraduate students. This selection was aimed at generating diverse opinions and criticisms based on the varying degree of knowledge, understanding and practical capabilities of the sampled group.

The pilot study reflected these varying degrees of an individual's capability to understand and interpret the questions posed by the questionnaires, which necessitated the following amendments being made to the questionnaires:

- The 'official' column included on the questionnaire created some confusion for the respondents. The column confused almost all the respondents. This necessitated completely deleting that column in the final draft.
- All the open-ended questions in the initial questionnaire were revised; these questions were replaced by multiple choice questions.
- The average time taken to complete each questionnaire was reduced from fifteen minutes to just under eight minutes (the same set of respondent was used to ascertain this), indicating that the final drafts were easier to understand, comprehend and complete.

## **5.5 Types and sources of data**

According to Corty (2007), the numbers that are assigned in the process of measurement could either take the form of qualitative or quantitative. In his opinion,

the qualitative numbers are arbitrary as they reflect neither rank nor distance; that is, they do not present any clear quantitative information.

On the other hand, quantitative numbers have the measurable attribute; that is, we could differentiate the objects based on the amount of an attribute; For example, the weight, height and rank that they each possess. The type of data used in this research is quantitative. This is done to show the precise level of significance that respondents attach to each of the research variables. Data used in this analysis have been elicited from the two sets of questionnaires administered.

## **5.6 Data analysis and processing**

Data collected through the survey using these sets of structured questionnaires were carefully analysed by using a series of computer software and a self-generated programme to suit the particular purposes of this research. In specific, SAS/STAT User's Guide, Version 8 was used to develop specific programmes considered to be suitable for this research. Microsoft packages were also used in further analyses.

## **5.7 The Likert scale**

A Likert rating scale of four dimensions was used in this research to measure the respondents' strength of agreement with the research variables. A scale of four is considered suitable because of its clear-cut affirmative nature. Although, the ranking scales of each question within and among these questionnaires differ in direct meaning (e.g. 1= strongly disagree; 2= disagree...4= strongly agree; or 1= very unfavourable; 2= unfavourable... 4= very favourable), it was thus considered appropriate to use a simple common means of representation. To achieve this, the following conversions were used:

1= very negative perception, indicated by 'negative- -'

- 2= negative perception, indicated by 'negative'
- 3= positive perception, indicated by 'positive'
- 4= very positive perception, indicated by 'positive+ +'

The above conversion makes it easy to capture the frequency of responses to each of the question categories and the rating/evaluation of responses on a categorical basis.

### **5.8 The frequency tables**

In each question category, the options are presented in a way so as to reflect the first two sets: '1 and 2' representing a negative sentiment, while the last two sets '3 and 4' represent the level of favourability of the specific issue under consideration.

**The one-way frequency tables:** The number of responses in each of the optional categories is presented by means of **one-way frequency** tables for the section A of both questionnaires.

**Two-way frequency** tables were used to record each response per category of questions probed in section B of the questionnaires. The ranking scale was used as the one dimension in each table and the number of sub-questions probed within each questionnaire item was regarded as the second dimension.

### **5.9 Concerns for validity and reliability**

Gravetter and Wallnau (2007) observe that validity of findings is established when a test measures exactly what it claims; that is, the test's relatedness of the scores on a test to the other related tests. Maxwell (1996) defines validity as the correctness or credibility of a description, explanation, interpretation, account, or conclusion. Three types of validity can be distinguished (Caldwell, 2006). They are criterion, content and construct validity respectively. These are explained below:

Criterion validity measures the instrument used in data collection, content validity deals with the substance in the measurement tools and construct validity tests the respondents' understanding of the measuring tools.

Reliability on the other hand deals with the consistence of the findings. Gravetter and Wallnau (2007:510) are of the opinion that a "...measurement procedure is considered reliable to the extent that it produces stable, consistent measurements. That is, a reliable measurement procedure produces the same (or nearly the same) scores when the same individuals are measured under the same conditions". As a scientific research, the need for reliability of the findings of this research was considered to be crucial.

As indicated earlier, the pilot study helped to identify inherent errors in the instrument and these errors were corrected in the final draft. Having corrected these errors, it is expected that the findings of this research could be regarded as valid and could justifiably be generalised to the entire study population.

### **5.10 Chapter summary**

This chapter discusses the methodology used in conducting this research. It highlights the procedures followed and the modalities adopted in conducting the research. It clearly depicts the chronological order of measures followed in carrying out the empirical research, the mode and instruments of analysis and the basis for arriving at a result that could be regarded as valid and reliable.

Chapter six will present the data analysis and interpretation, from which conclusions will be drawn and possible intervention mechanisms will be suggested.

## **CHAPTER SIX**

### **DATA ANALYSIS AND INTERPRETATION**

#### **6.1 Introduction**

This chapter will present the findings of the field surveys in which both the investors and the policy makers were interrogated on various policy issues that are assumed to have effects on the investment climate of South Africa. The analysis will be presented separately for each of the research groups, namely the policy makers and the foreign investors. The chapter will also consider the similarities/dissimilarities of the information supplied by these groups, as they relate to the research objectives.

#### **6.2 Types of data and the method of analysis applied**

As stated in chapter five, each set of questionnaires is divided into two sections: Section A deals with the details of respondents and section B interrogates investment/policy related issues (see appendices 3 and 4). Likert scales of 1-4 were used to guide respondents (see section 5.7). Statistical frequency tables were also used as well as cross-tabulation in both the analyses and test of hypotheses (see section 5.5 for the types of data used in this study). The method and procedures for data analysis was equally discussed in section 5.6.

#### **6.3 Presentation of results**

Results of both the 'details of respondents' and 'investment/policy related issues' ratings are presented in the same sequential order in which the questions were outlined in the questionnaires. The questionnaire items for the policy makers' were numbered as 'bb1' to 'bb13' to correspond with the section 'B1' to 'B13' of the questionnaire. Similarly, sections 'B1' to 'B12' of the investors' questionnaires were numbered as 'qq1' to 'qq12'.

### 6.3.1 The analysis

#### 6.3.1.1 The policy makers survey group

One-way frequency tables illustrating the distribution of details of sampled policy makers

Table 1: Position of respondent

Position of respondent				
Position	Frequency	Percent	Cumulative Frequency	Cumulative Percent
Others	6	100.00	6	100.00

From the table above, it is evident that all the policy makers sampled chose the 'others' option, as they do not belong in the specified positions of authority. They were all 'Deputy Directors' of their various departments, including a provincial MEC.

On the length of service of the respondent within the organisation, the following responses were generated:

Table 2: Length of service

Period of service within the organization				
Period	Frequency	Percent	Cumulative Frequency	Cumulative Percent
< 1 yr	1	16.67	1	16.67
1-5 yrs	3	50.00	4	66.67
6-10 yrs	1	16.67	5	83.33
>10 yrs	1	16.67	6	100.00

The table indicates that more than 80 per cent of the respondents have worked for more than two years in their respective organisations, thereby making them appropriate to respond adequately to the research variables.

**Two-way frequency tables illustrating the perception of sampled policy makers on the various investment policy issues**

Question B1: Favourable investments for South Africa. The following table presents their responses:

Table 3: Favourable investment for SA

Table of item 1 by bb1					
Item 1	bb1 (Favourite foreign investment for SA)				Total
Frequency	negative - -	negative	positive	positive ++	
Mergers/acquisitions	1	1	2	0	4
Greenfield investments	0	1	0	5	6
Licensing	1	1	1	0	3
Joint ventures	0	0	3	3	6
Strategic alliances	0	0	4	1	5
Total	2	3	10	9	24
<b>Frequency Missing = 6</b>					

From table 3, about 64 per cent of respondents favour greenfield investments and strategic alliances. This may perhaps confirm why the government promotes greenfield investments (FDI) more than any other form of investment; although government has not been 'successful' in attracting this kind of investment.

Question B2: Reasons for favouring investments in B1

Table 4: Reasons for favouring investment in B1

Table of item 2 by bb2				
Item 2	bb2 (Reason for preference)			Total
Frequency	negative - -	negative	positive ++	
Employment effects	0	0	5	5
Export promotions	1	0	4	5
Foreign earnings effects	0	0	4	4
Import substitution effects	0	0	3	3
Benefits: other organisations	0	1	3	4
<b>Total</b>	1	1	19	21
<b>Frequency Missing = 9</b>				

From table 4, all the benefits examined were considered relevant by policy makers, with employment and export promotions effects taking the lead. It thus appears that government promotes greenfield (FDI) and strategic alliances, inter alia, to create employment and also to improve exports; the targets that have been missed due to low records of investments of these kinds.

Question B3: The competitiveness of South African policies in attracting FDI

The question interrogates the competitiveness of South African policies designed to attract inflow FDI as compared to other developing countries.

As indicated in table 5, the responses generated indicate that some polices were considered to favour South Africa's investment rating, while others were considered less competitive. Specifically, tax holiday and import substitution appear to be less competitive, while unrestricted profit remittance and exchange control liberalisation appear to be the more competitive policies that could possibly attract foreign



investors to South Africa. It may thus be difficult for South Africa to compete against a country like India, Singapore and Mexico, which rate higher in these aspects.

Table 5: Competitiveness of SA's investment policies

Table of item 3 by bb3					
Item 3	bb3 (Competitiveness of SA policies)				Total
Frequency	negative - -	negative	positive	positive ++	
Tax holidays/depreciation	3	0	0	0	3
Import substitution strategy	2	1	0	1	4
Export promotion subsidy	0	3	0	2	5
Exchange control liberalization	1	1	2	1	5
Unrestricted profit remittance	1	0	2	3	6
Total	7	5	4	7	23
Frequency Missing = 7					

Question B4: The particular policies/issues that attract investors to South Africa

This question probes the particular kind of government policy the policy makers believe will attract investors to South Africa. Here, the responses of policy makers surveyed indicate a positive judgment:

Table 6: Favourable policies to investors

Table of item 4 by bb4					
Item 4	bb4 (Attractive SA government policies:)				Total
Frequency	Negative - -	negative	Positive	positive ++	
Investment incentives	1	1	0	4	6
Fiscal policy	0	0	2	4	6
Monetary policy	1	0	2	3	6
Infrastructure	0	1	0	5	6
Market size/ growth	1	1	2	2	6
Total	3	3	6	18	30

From table 6, respondents are of the opinion that all the variables interrogated are important to attracting FDI to South Africa, placing more preference on infrastructure, investment incentives and fiscal policies. But the recent (2008) Global Competitiveness Report shows that South Africa is far behind in infrastructure, where countries like Chile, Mexico and Brazil top the list.

Question B5: Complaints of investors

The question investigates the obstacles that confront foreign investors at the initial stage of their investments in South Africa. All the problems presented appear to be significant as portrayed by table 7:

Table 7: Obstacles to investors

Table of item 5 by bb5				
Item 5	bb5 (Foreign investment obstacles/complaints)			Total
Frequency	negative	positive	Positive ++	
Too many contact points	0	4	1	5
Delay in registration	0	3	2	5
Documentation	0	3	2	5
Envirnm assessment process	2	0	4	6
Bureaucratic process	1	2	3	6
<b>Total</b>	<b>3</b>	<b>12</b>	<b>12</b>	<b>27</b>
<b>Frequency Missing = 3</b>				

The general perception of the administrative huddles examined was positive, indicating that all the variables tested constitute some level of barrier to investors; this buttresses the negative rating of South Africa's public service system.

Question B6: Important sectors for South Africa's economy

Overall, with the exception of farming/agro-processing, which elicited a divided response from the respondents; all the sectors examined seem to be of importance to the South African economy.

While manufacturing and information/communication technologies are seen to be very important, the importance of agriculture/agro-processing activities was rated a bit less important. Both mining and financial services were considered equally important. This may help explain why the drivers of current inflation will continue to receive very little attention.

Table 8: Important sectors to SA's economy

Table of item 6 by bb6				
Item 6	bb 6 (Importance-rating of sectors in SA economy)			Total
	negative	positive	positive ++	
Farming/agro-processing	2	0	2	4
Mining	1	1	4	6
Manufacturing	0	1	5	6
Financial services	0	1	4	5
Information/comm. technology	0	1	5	6
<b>Total</b>	<b>3</b>	<b>4</b>	<b>20</b>	<b>27</b>
<b>Frequency Missing = 3</b>				

Question B7: Presence of foreign investors in the industries

From table 9, although foreign investors are present in all the sectors listed, but their lesser presence in the farming/agro-processing sector shows that food production will remain a problem for some time to come, and hence, continued inflation and its associated poor rating of South Africa as a favourable investment destination.

Table 9: Presence of foreign investors in the industries

Table of item 7 by bb7				
Item 7	bb7 (Presence of Foreign investment in:)			Total
Frequency	negative	positive	positive ++	
Info/com technology	0	3	3	6
Financial/banking services	0	2	4	6
Manufacture/construction	0	4	2	6
Farming/agro-processing	1	3	1	5
Marketing/ distribution.	1	3	2	6
<b>Total</b>	<b>2</b>	<b>15</b>	<b>12</b>	<b>29</b>
Frequency Missing = 1				

Question B8: The impact of some industries on the South African economy

The question looks at the industries that best support the South African macroeconomic policy frameworks (e.g. the GEAR and ASGISA). It was found that all the listed industries contribute to achieving the policy targets of the GEAR and ASGISA. This may signified a continued internal support for these policy initiatives.

Table 10: Industry contributions to SA economy

Table of item 8 by bb8				
Item 8	Bb 8 (Contributions to SA economy)			Total
Frequency	Negative	Positive	Positive ++	
Info/ com technology	0	2	4	6
Financial/banking services	0	1	5	6
Manufacture/construction	0	2	4	6
Farming/agro-processing	2	1	2	5
Marketing/ distribution.	3	2	0	5
<b>Total</b>	<b>5</b>	<b>8</b>	<b>15</b>	<b>28</b>
Frequency Missing = 2				

Question B9: Addressing unemployment

This question assesses the perception of policy makers on the particular sector that should be targeted with incentives regarding addressing unemployment in South Africa. From table 11, it was discovered that manufacturing and information/communication technology were considered the most in need of incentives. Although, these industries are incentivised (section 8.4), they are still unable to generate meaningful employment opportunities, capable of reducing associated crime rate; a move towards creating a conducive investment environment.

Table 11: Sector that could alleviate unemployment

Table of item 9 by bb9				
Item 9	bb 9 (Employment incentives, industries:)			Total
Frequency	negative	positive	Positive ++	
Farming/agro-processing	1	2	2	5
Mining	2	1	2	5
Manufacturing	0	0	4	4
Financial services	1	2	2	5
Information/comm technology	1	1	4	6
<b>Total</b>	5	6	14	25
<b>Frequency Missing = 5</b>				

Question B10: Growth/profitability of FDI in South Africa

The question examines the particular macroeconomic policy that hinders the profitability and growth of foreign investments in South Africa. Responses generated from the sampled policy makers indicate that GEAR is viewed as a lesser obstacle compared to high interest rates and labour issues. This confirms the findings in the literature survey.

Table 12: Growth and profitability of FDI in SA

Table of item 10 by bb10					
Item 10	bb10 (Obstructive macro-economic policies:)				Total
Frequency	negative - -	negative	positive	positive ++	
The GEAR	2	0	2	1	5
Tight fiscal policy	1	0	3	1	5
High interest rates	0	0	3	3	6
Labour issues	0	1	2	3	6
Total	3	1	10	8	22
Frequency Missing = 2					

#### Question B11: Policy reforms

This question investigates the specific policy that should be reformed to make South Africa more attractive to FDI. It was discovered that high interest rates, labour related issues/policies, and Immigration Acts/expatriate related policies appear to be in need of reform. Although, the Empowerment Charters and the Income Redistribution mechanism were also seen as important, but not significantly so.

#### Question B12: Other issues/variables that hinders the inflow of FDI to South Africa

The respondents were of the opinion that crime related issues, a relatively small market size, and shortages in the supply of skilled labour have significantly negative effects on the inflow of FDI to South Africa. The same sentiment was expressed in the literature survey:

Table 13: Other issues/forces that hinder inflow FDI to SA

Table of item 12 by bb12				
Item 12	bb12 (Obstacles to FDI flow in SA:)			Total
Frequency	Negative --	positive	positive ++	
Political instability	2	0	1	3
Relatively small market size	0	1	4	5
Skilled labour shortage	0	2	2	4
Crime related issues	0	1	5	6
<b>Total</b>	2	4	12	18
<b>Frequency Missing = 6</b>				

Question B13: Addressing inequalities in South Africa

This question examines the opinions of respondents on the macroeconomic policies considered capable of addressing inequalities in South Africa. It is generally agreed that ASGISA is seen to be the most capable policy in addressing inequalities in South Africa. This may justify the internal support for this policy initiative, but the impact of tax policy reforms was, unfortunately, not given the required attention for reforms, considering its importance to foreign investors.

Table 14: Addressing inequality in SA

Table of item 13 by bb13					
Item 13	bb13 (Macro-economic policies addressing SA's inequalities)				Total
Frequency	negative --	negative	Positive	positive ++	
Tax policy reform	0	0	0	3	3
The GEAR	1	1	1	2	5
ASGISA	0	0	1	5	6
Something new	0	0	0	1	1
<b>Total</b>	1	1	2	11	15

### Question B14: Making South Africa more attractive to FDI

The question required respondents to comment on possible solutions to making South Africa more attractive to foreign investors. This question was largely avoided. The only response suggests providing incentives to profitable industries that most require it, while discouraging monopoly, oligopoly, and their associated vices.

### 7.3.2 The investors' survey group

One-way frequency tables illustrating the distribution of details of sampled investors

Table 15: Official capacity of respondents

Position of respondent		
Position	Frequency	Cumulative Frequency
CEO	3	3
Regional Director	1	4
Managing Director	6	10
Top Management	8	18
Divisional Manager	5	23

From table 15, it is indicated that the respondents range from CEOs through to divisional managers, thereby making them appropriate to adequately answer the questions raised in this research.

Regarding the period for which the organisation has been operating in South Africa, table 16 indicates that 75 per cent of the sampled organisations have operated for more than 10 years in South Africa, suggesting that they can relate well with the macroeconomic dynamics of South Africa.



Table 16: Period of operating in SA

Period of operation in SA		
Period	Frequency	Cumulative Frequency
2-5 yrs	2	2
6-10 yrs	4	6
>10 yrs	18	24

The same procedure was followed for the interpretation of the other one way frequency tables. i.e. the industry of respondents, the scope of the business, number of employees and financial turnover.

**Two-way frequency tables illustrating the perceptions of foreign investors on the various investment/ policy related issues.**

The interpretation of all the two-way tables is done by first examining the row of total frequencies in the table (e.g. for question B1 – **table 17**, the deduction could be made that respondents generally regard the location of a foreign subsidiary as an important issue). This finding is based on the fact that the majority of respondents responded positively (38) and very positively (38), totalling 72, and place importance on location specific issues, as opposed to 12 very negative and six negative responses totalling 18.

Also, by taking the rating-frequencies of a question option (e.g. market size in B1), and comparing it to the same rating frequency of another question option (e.g. political stability in the same B1), deductions can be made as to which option is measured more positively or negatively by respondents.

For example, in section B1 of the investors' questionnaire, the elicited response indicates that the positively rated frequencies for 'market size/growth potential' is six plus fifteen equals twenty one; for 'political stability' and 'monetary and fiscal

policies’ eighteen and nineteen respectively and also eighteen for ‘access to global markets’.

Given that 15 respondents indicate ‘market size/growth potential’ as positive++, the deduction can be made that ‘market size/growth potential’ is considered the most important foreign subsidiary location consideration among the surveyed investors, closely followed by ‘monetary/fiscal policies’, ‘political stability’ and lastly, ‘access to global markets.’

It is noted that the last option in each question labelled ‘others’ was generally omitted as none of the respondents considered this option necessary.

The first question that investigates the importance attached to a set of issues whenever a foreign investment destination is to be chosen has been used above for the practical analysis in the example above. The implication here is that an enlarged market capacity, inter alia, is capable of attracting more FDI to South Africa (research sub-objective a).

Table 17 reflects the feelings of respondents as presented in the example that is demonstrated above:

Table 17: Foreign subsidiary location considerations

Table of item 1 by qq1					
Item 1	qq1 (Foreign investment location-considerations)				Total
Frequency	negative --	negative	positive	positive ++	
Market size/ growth potential	3	0	6	15	24
Access to global markets	3	2	13	5	23
Political stability	3	2	9	9	23
Monetary/ fiscal policies	3	2	10	9	24
<b>Total</b>	12	6	38	38	94

This analysis is structured accordingly to show the exact weight attached to each consideration by the investors. It will be unrepresentative enough to place ‘access to global markets’ above ‘political stability’ even though, they both rate equally, but for the fact that ‘political stability’ is more positively (nine ++) considered than ‘access to global markets’ (which has only five ++).

Question B2: South Africa’s competitiveness

The question investigates the rating of a list of South African investment policies as compared to other developing nations. The general response indicates that these listed policies are more favourably rated in the case of South Africa than for other developing nations, except for the local contents policy. This may imply that investors in these industries value the incentives that are attached to their industries (research sub-objective b). Table 18 explains the response pattern further:

Table 18: Competitiveness of SA’s investment policies

Table of item 2 by qq2					
Item 2	qq 2 (SA trade/investment policy-ratings)				Total
Frequency	negative - -	negative	positive	positive ++	
Business approval requirements	1	5	15	1	22
Wholly-owned subsidiary policy	0	5	17	0	22
Profit remittance policy	1	5	15	0	21
Local content policy	0	8	13	1	22
<b>Total</b>	2	23	60	2	87
<b>Frequency Missing = 9</b>					

Question B3: Prospects for profitability and growth

The question centres on the aspect of South Africa’s political economy that offers prospects for profitability and growth, compared to other developing nations like India and China (research sub-objective d).

Generally, all respondents (table 19) see the listed political economies as facilitating investment profitability and growth. This conforms to table 12 of the policy makers.

Table 19: Prospect for profitability/growth

Table of item3 by qq3					
Item 3	qq 3 (SA political economy profitability-aspects)				Total
Frequency	negative - -	negative	positive	positive ++	
Political stability	4	2	12	4	22
Economic growth	0	3	13	6	22
Socio-cultural issues	3	3	15	1	22
Legal frameworks	3	6	14	1	24
Total	10	14	54	12	90
<b>Frequency Missing = 6</b>					

Question B4: Favourable policies

The question investigates the specific fiscal/monetary policy that most favours the industry/organisations of respondents. From table 20, it is suggested that responses varied widely among respondents on whether any particular policy favours their organisation or industry. This may suggest that respondents are divergent on favourable indicators, given that they operate in different industries. For this reason, a blanket policy cannot be designed to attract a wide spectrum of FDI (the main research objective).

Table 20: The most favourable policy

Table of item 4 by qq4					
Item 4	qq4 (Favourite SA monetary policy for FDI)				Total
Frequency	negative - -	negative	positive	positive ++	
Tax holidays	5	5	5	6	21
Provision for depreciation	5	3	15	0	23
Import substitution/ restr.	1	11	7	0	19
Export subsidies/ incentives	6	4	4	5	19
<b>Total</b>	17	23	31	11	82
<b>Frequency Missing = 14</b>					

Question B5: Labour policies as hindrance to growth

This question looks at the impact of listed labour policies on the performance and attractiveness of the respondents' industries. From table 21, the general impression is that respondents consider the listed labour policies as obstacles to the performance of their industries. This is in consonance with the general criticism of the unfavourableness of South Africa's labour related policies, as indicated in the literature survey as well as the 2008 Global Competitiveness Report that ranks the South African labour market efficiency 78 out of 131 countries (hypothesis 1).

Table 21: The effect of labour policies

Table of item 5 by qq5					
Item 5	qq5 (SA labour policy hindering investors performance)				Total
Frequency	Negative - -	negative	positive	positive ++	
Employment Equity Act	4	10	6	3	23
Broad Based Black Eco. Emp.	4	12	8	0	24
Severance Package scheme	0	12	9	0	21
Affirmative action	3	8	12	0	23
Total	11	42	35	3	91
Frequency Missing = 5					

Question B6: Response of industries to a set of policies

The question interrogates the respondents' opinion on a set of economic/fiscal policies. In table 22, it can be seen that the effects of these policies on the examined industries are very significant (both positively and negatively). The response pattern generally suggests that the high interest rates have not been helpful to these industries; thereby suggesting a possible reform (hypothesis 1).

Table 22: Response pattern to policies

Table of item 6 by qq6					
Item 6	qq6 (Investor's response to fiscal policies:)				Total
Frequency	negative - -	negative	positive	positive ++	
Flexible foreign exchange regime	0	4	14	4	22
Increased interest rates	5	12	7	0	24
Low inflation rate	0	2	17	4	23
Government budget austerity	0	3	14	4	21
Total	5	21	52	12	90
Frequency Missing = 6					

Question B7: Necessary policy reforms

The question (table 23) examines the specific policy reforms that could possibly make the respondents' industries more competitive. While there is a noticeable variation in the level of importance attached to each of the policies listed by the respondents, there is a general support for reforms of all the policies investigated (hypothesis 1).

Table 23: Necessary policy reforms

Table of item7 by qq7				
Item 7	qq7 (Policy reforms favoured by investors)			Total
Frequency	negative	positive	positive ++	
Broad-Based Empowerment Cha.	6	8	9	23
Flexible foreign exchange	1	12	7	20
Organised Labour Acts	4	9	5	18
National bilateral trade agreem.	5	9	7	21
<b>Total</b>	16	38	28	82
<b>Frequency Missing = 14</b>				

Question B8: Factors that hinder FDI inflow to South Africa

The question in table 24 examines the specific issues/factors that investors perceive to be hindrances to the inflow of FDI to South Africa. While all factors were considered significant, crime and corruption were considered to be of greater significance (hypothesis 2, sub-objective e)

Table 24: Factors that impact on FDI

Table of item 8 by qq8				
Item 8	qq8 (Issues hindering inflows of FDI to SA)			Total
Frequency	negative	positive	positive ++	
Political instability	3	13	8	24
Shortage in supply of skilled labour	4	9	8	21
Relatively small market size	5	14	3	22
Crime and corruption	0	7	17	24
<b>Total</b>	<b>12</b>	<b>43</b>	<b>36</b>	<b>91</b>
<b>Frequency Missing = 5</b>				

Question B9: Perceptions about macroeconomic policies and the ruling party's ideology

This question in table 25 probes the opinion of investors on the South Africa's investment environment, especially the ideology of the ruling political party.

Table 25: Perception about ANC policy

Table of item 9 by qq9					
Item 9	qq9 (Perception of SA/ ANC's macroeconomic policies:)				Total
Frequency	negative - -	negative	positive	positive ++	
Stable and favourable	0	4	18	2	24
Unfavourable and volatile	5	8	3	3	19
Unfavourable but stable	1	5	10	0	16
Favourable but unstable	0	13	6	0	19
<b>Total</b>	<b>6</b>	<b>30</b>	<b>37</b>	<b>5</b>	<b>78</b>
<b>Frequency Missing = 18</b>					



Investors generally expressed positive sentiments about South Africa’s macroeconomic policies and the political ideology of the ruling ANC party. This suggests that investors still feel comfortable with the policy direction of the ruling political party (research sub-objectives c and d). This may support the criticism that the government’s policies are informed by the wishes/agitations of the business class (as suggested in the literature survey).

Question B10: The cost structure of respondents’ organisations

The question looks at the percentage of operating costs spent on certain activities. Table 26 indicates that the majority of respondents spend more on human capital development than on anything else. The costs of corporate social responsibility (CSR) and, security and crime are also significant, buttressing the point of skills shortage, poverty and crime, as militating against industrial efficiency in South Africa (hypothesis 2).

Table 26: The cost structure of organisations

Table of item10 by qq10					
Item 10	qq10 (%Operating cost breakdown of investors)				Total
Frequency	<10%	<20%	<25%	+ 35%	
Security and crime	18	3	0	1	22
Cost padding	16	0	0	0	16
Human capital development	9	5	5	4	23
Corporate/ social resps.	12	1	8	2	23
<b>Total</b>	55	9	13	7	84
Frequency Missing = 12					

Question B11: Area of future expansion as regards the organisation's growth strategy

The question looks at the possible areas of expansion and the expected percentage of corporate budget to be committed to the growth strategy, including the sector targeted by the expansion (research sub-objective a). The response generated indicates that agriculture is the one that benefits the least from these expansion strategies. This is further explained in table 27:

Table 27: Expansion focus area

Table of item11 by qq11					
Item 11	qq11 (% And sector investor plans to extend)				Total
Frequency	<10%	<20%	<25%	+ 35%	
Agriculture	6	3	0	0	9
Mining	3	3	2	3	11
Info technology	1	1	4	2	8
Transport	1	1	6	2	10
Total	11	8	12	7	38
Frequency Missing = 58					

Respondents in general indicate that they will be expanding their operations in the information technology and transportation sectors. With increase in food prices being one of the variables that triggers current consumer price index (CPIX) inflation, effort is required to boost investment in agriculture.

Question B12: Addressing inequalities in South Africa

Table 28: Addressing inequality in SA

Table of item12 by qq12					
Item12	qq12 (Macroeconomic policies to address inequalities in SA)				Total
Frequency	negative - -	negative	positive	positive ++	
Tax policy reform	4	0	1	16	21
The GEAR	0	8	1	10	19
The ASGISA	1	6	2	9	18
Something new?	0	0	0	0	0
<b>Total</b>	5	14	4	35	58
<b>Frequency Missing = 38</b>					

The question investigates the macroeconomic policy that is capable of addressing the prevailing inequalities in South Africa, as a way of reducing poverty thereby expanding the domestic market size (research hypothesis 2). Respondents did not suggest anything new; they only responded to the options listed. Table 28 suggests that respondents were generally convinced that ‘tax reforms’ is the policy most capable of addressing the prevalence of inequalities in South Africa.

The last question that attempts to uncover the why South Africa is presumed to be less competitive, as compared to other developing nations was generally avoided.

#### 6.4 Test of hypothesis

The final phase in this research is to test the impact of investment related policies and other issues on the attractiveness of South Africa for the inflow of FDI. Here, the opinion of the policy makers and the investors on certain policy and other issues were compressed into combined contingency tables. This is done to reflect the level of significance of each of the variables tested in the questionnaire.

More precisely, questions B11, B12 and B13 of the policy makers' questionnaire were combined with the corresponding questions B7, B8, and B12 on the investors' questionnaire. The two sets of questionnaires were combined to generate three contingency tables with Pearson's Exact Chi-squared test being used to obtain the significance levels of the variables tested in each of the compressed questions.

In the following frequency tables, the first entry in each cell is the frequency, the second entry in each cell is the cell-chi-square contribution, the third entry is the percentage of responses in relation to all responses represented by the cell, and the fourth entry is the percentage of responses present in the particular row of the table.

In analysing the data collected, significance is established if the probability associated with the test statistic of the particular test is less than 0.05 (5% level of significance), or less than 0.01 (1% level of significance) or less than 0.001 (0.1% level of significance). This is indicated as 'Pr > chi-sq' in the analysis results. In addition, 'I' is used to denote investors while 'P' is used to denote policy makers.

#### **6.4.1 Hypothesis 1** (as stated in 1.8)

H<sub>01</sub>: Investment related policy frameworks (mainly the macroeconomic policies) **do not improve** the attractiveness of South Africa to inflow FDI.

H<sub>a1</sub>: Investment related policy frameworks (mainly the macroeconomic policies) **improve** the attractiveness of South Africa to inflow FDI.

**6.4.1.1** The condensed table below with associated Pearson's Exact significance tests, represents policy reforms suggested by respondents (Policy makers' B11 and investors' B7 questions).

Table 29: Hypothesis 1

Table of reform I by reform P				
Reform I	Reform P (Favourite FI-policy-reform rating:)			Total
	negative	positive	Positive ++	
Frequency				
Percent				
Row Percent				
<b>Empowerment Charters</b>	6	11	9	26
	5.88	10.78	8.82	25.49
	23.08	42.31	34.62	
<b>High interest rates</b>	2	13	11	26
	1.96	12.75	10.78	25.49
	7.69	50.00	42.31	
<b>Labour policies</b>	5	9	10	24
	4.90	8.82	9.80	23.53
	20.83	37.50	41.67	
<b>Income redistribution</b>	7	11	8	26
	6.86	10.78	7.84	25.49
	26.92	42.31	30.77	
<b>Total</b>	20	44	38	102
	19.61	43.14	37.25	100.00

Table 30: Chi square test

Pearson Chi-Squared Test	
Chi-Square	3.8849
DF	6
Asymptotic Pr > ChiSq	0.6922

The FREQ Procedure  
 Statistics for table of reform I by reform P

Table 31: Estimate for Exact test

Monte Carlo Estimate for the Exact Test	
Pr >= Chi Sq	0.6460
99% Lower Conf Limit	0.6337
99% Upper Conf Limit	0.6583
Number of Samples	10000
Initial Seed	1943940033

Sample Size = 102

From tables 31, the probability associated with the Pearson's Exact test for the policies listed above is greater than 0.05 – it is indicated as **0.6460** (it is given as 'Pr <= Chi Sq' in the analysis results above, where chi-square = 3.8849 and where the probability associated with the statistic is 0.6460) thus indicating non-significance.

Significance in this instance would have indicated that investors and policy makers did not respond in a similar way to all the options – that they 'preferred' some policy-options to others. This could not be established in this instance- implying that they did not prefer a specific option to others.

One can however establish that the respondents' general perception of policy reforms was positive. The majority of the responses were indicated as 'positive' to 'positive++'. By implication, this confirms that all the listed policies need to be reformed to make South Africa more attractive for the inflow of FDI.

As a result, the null hypothesis  $H_{01}$ : 'Investment related policy frameworks (mainly the macroeconomic policies) **do not improve** the attractiveness of South Africa to inflow FDI' is not rejected while the alternative hypothesis ( $H_{a1}$ ), which states that, 'Investment related policy frameworks (mainly the macroeconomic policies) **improve** the attractiveness of South Africa to inflow FDI' is rejected.

#### 6.4.2 Hypothesis 2 (as stated in 1.8)

H<sub>02</sub>: **Only** Investment related policies **hinder** the attractiveness of South Africa to inflow FDI.

H<sub>a2</sub>: Investment related policies **are not** the only variables that **hinder** the attractiveness of South Africa to inflow FDI.

**6.4.2.1** The following condensed table (table 32) containing associated Pearson's Exact significance tests, represents responses generated from the combined questionnaires (policy makers' B12 and investors' B8 questions). The two corresponding questions elicit information about other factors that hinder the inflow of FDI to South Africa. This validates the findings of hypothesis 1 above.

Table 32: Hypothesis 2

Table of FDI I by FDI P				
FDI I	Obstacles to inflow FDI to SA			Total
Frequency Cell Chi-Square Percent Row Pct	negative	positive	positive ++	
Political instability	3	13	9	25
	0.0137	0.3711	0.4375	
	2.80	12.15	8.41	23.36
	12.00	52.00	36.00	
Skilled labour shortage	4	10	12	26
	0.4031	0.1767	0.0097	
	3.74	9.35	11.21	24.30
	15.38	38.46	46.15	
Small market size	5	16	5	26
	1.4896	1.8363	3.807	
	4.67	14.95	4.67	24.30
	19.23	61.54	19.23	
Crime	0	8	22	30
	3.3645	2.0343	5.4218	
	0.00	7.48	20.56	28.04
	0.00	26.67	73.33	
Total	12	47	48	107
	11.21	43.93	44.86	100.00

Statistics for Table of FDI I by FDI P

Table 33: Chi square test

Pearson Chi-Squared Test	
Chi-Square	19.3652
DF	6
Asymptotic Pr > ChiSq	0.0036

The FREQ Procedure  
 Statistics for table of FDI I for FDI P



Table 34: Estimate for Exact test

Monte Carlo Estimate for the Exact Test	
Pr >= Chi Sq	0.0027
99% Lower Conf Limit	0.0014
99% Upper Conf Limit	0.0040
Number of Samples	10000
Initial Seed	458046001

From table 34, the probability associated with the Pearson's Exact test for the factors/issues that hinder inflow FDI to South Africa, as listed above is less than 0.05. It is indicated as **0.0027** (it is indicated as 'Pr <= Chi Sq' in the analysis results above, where chi-square = 19.3652 and where the probability associated with the statistic is 0.0027), thus indicating significance.

A critical evaluation of the values of the cell-chi-square in the two tables (for hypothesis one and hypothesis two respectively) indicates that the cell-chi-square values for each variable tested in the second table are higher than those of the first table. This indicates that although, policy reforms will improve South Africa's attractiveness to inflow FDI, the impact of other variables (tested in table two) is also seen to be significant.

As a result, the second null hypothesis – H<sub>02</sub>: '**Only** Investment related policies **hinder** the attractiveness of South Africa to inflow FDI is rejected while the alternative hypothesis – H<sub>a2</sub>: Investment related policies **are not** the only variables that **hinder** the attractiveness of South Africa to inflow FDI' is not rejected.

More importantly, the table indicates that investors and policy makers did not respond in similar way to all issues. That is, they rated some issues more important

than others. In the contingency table, the cell-chi-values help identify the most important issues.

The cell-chi-values 5.4218 for crime (with a frequency of 22 for the positive++ category) and 3.3645, also for crime in the cell-chi-square contribution (with a frequency of zero for the negative category) indicate that respondents viewed crime in a significantly different way to the other FDI issues. **They generally regarded crime as an important variable that hinders the attractiveness of South Africa to inflow FDI.**

To buttress this point, South Africa spends a considerable amount of money on the police, courts and prisons (amounting to three per cent of GDP in 2004, or an average of \$130 per person on criminal justice, as compared to the world average of one per cent or \$66 per person) (EIU Country ViewsWire, 2004). This is a clear indication that crime is indeed, a real problem that must be tackled. The Global Competitiveness Report (2007-2008) ranks South Africa 116<sup>th</sup> out of 131 countries on the business costs of crime and violence, and 92<sup>nd</sup> on the unreliability of police services to protect victims from crime.

The cell-chi-value of 3.807 for small market size (with a frequency of five for the positive++ category) indicated that, although small market size was still an important issue if the 'positive' and 'positive++' categories are grouped together, it is not regarded as being of the same importance as crime. Calculating 'positive' responses for the other issues indicates that respondents see all the variables tested as hindering FDI inflow to South Africa, but most importantly, crime.

The field survey reveals that crime, small market size, political instability, and skilled labour shortages in South Africa are major deterrents to the inflow of FDI to the country. In addition, and having established from the literature survey that these

variables are closely linked to inequality; this research looked at a set of initiatives that are capable of addressing inequality in the country.

### 6.4.3 Income inequality

The literature review indicates that lack of social and economic opportunities are the major causes of crime. As a result, the following condensed tables (policy makers' question B13 and the corresponding investors' question B12) were designed to generate responses with associated Pearson's Exact significance test, about the possible policy that is capable of redressing the current inequality in South Africa, thereby ameliorating other associated vices that hinder South Africa's attractiveness to inflow FDI. The following information was generated:

Table 35: Addressing inequality

Table of inequality I by inequality P					
Inequality I	Inequality				Total
Frequency Cell Chi-Square Percent Row Pct	negative - -	negative	positive	positive ++	
Tax policy reform	4	0	1	19	24
	2	5	0.5	1.0667	
	5.56	0.00	1.39	26.39	33.33
	16.67	0.00	4.17	79.17	
GEAR	1	9	2	12	24
	0.5	3.2	0	0.6	
	1.39	12.50	2.78	16.67	33.33
	4.17	37.50	8.33	50.00	
ASGISA	1	6	3	14	24
	0.5	0.2	0.5	0.0667	
	1.39	8.33	4.17	19.44	33.33
	4.17	25.00	12.50	58.33	
Total	6	15	6	45	72
	8.33	20.83	8.33	62.50	100.00

Table 36: Chi square test

Pearson Chi-Square Test	
Chi-Square	14.1333
DF	6
Asymptotic Pr > Chi Sq	0.0282

**The FREQ Procedure**  
**Statistics for table of FDI I for FDI P**

Table 37: Estimate for the Exact test

Monte Carlo Estimate for the Exact Test	
Pr >= Chi Sq	0.0222
99% Lower Conf Limit	0.0184
99% Upper Conf Limit	0.0260
Number of Samples	10000
Initial Seed	477453001

The probability associated with the Exact test for the policies capable of addressing inequality in South Africa as listed above is less than 0.05. It is indicated as **0.0222** (given as 'Pr <= Chi Sq' in the analysis results above, where chi-square = 14.333 and where the probability associated with the statistic is 0.0222) thus indicating significance.

Significance in this instance indicates that investors and policy makers did not respond in a similar way to all policies capable of addressing inequality in South Africa. They rated some policies significantly more important than others; in the contingency table, the cell-chi-values assist in identifying the most important policies.

The cell-chi-value of 1.0667 for the 'positive++' category of the tax reform policy indicates that respondents regarded this policy as very important since the cell frequency associated with this cell is nineteen – indicating significantly stronger agreement than the other policies (in total, twenty respondents indicated tax reform as important as opposed to positive responses of fourteen and seventeen for GEAR and ASGISA respectively).

Although, respondents agreed that the three policies mentioned are important in addressing inequality in South Africa, tax reform was regarded as significantly more reformative than any other policies, with ASGISA scoring the least in rating (0.0667).

## **6.5 Interpretation of findings**

The findings of this research will be interpreted based on the results generated from the empirical survey, i.e. the primary sources (the two in-depth questionnaires).

To start with, this interpretation will centre basically on the two main problems that this research addressed (the research hypotheses), namely the effectiveness of the policy framework in attracting FDI to South Africa and also, the impact of other issues/forces on the attractiveness of South Africa as a favourable destination for FDI. The summary of findings and conclusions will be discussed in the chapter that follows (chapter seven).

## **CHAPTER SEVEN**

### **SUMMARY OF FINDINGS, RECOMMENDATIONS AND CONCLUSIONS**

#### **7.1 Introduction**

The previous chapter (chapter six) presented the results of the field survey. Responses generated from the questionnaires were analysed and interpreted to achieve the objectives set (both main and sub-objectives) as well as to test the research hypotheses.

This chapter aims at presenting the summary of findings and then recommending the necessary measures to make South Africa more attractive to inflow FDI.

#### **7.2 Findings of the research**

The findings of this research will be summarised to enable reliable conclusions to be drawn as well as valuable recommendations to be made. This chapter will focus on the empirical aspect of the research.

##### **7.2.1 The empirical research**

Chapter six focused primarily on data analysis and interpretation of the results. In chapter six, various responses of the policy makers and foreign investors were grouped and analysed. The research hypotheses were tested using the Pearson's Exact test. The Pearson's Exact test was deemed appropriate because of its level of reliability, and more specifically, because of the nature of the responses generated, which made it statistically inappropriate to use other analytical tools like the regression method of analysis.

### **7.2.2 Inference**

On the whole, the Pearson's Exact Significance tests conducted to test the reliability and appropriateness of some macroeconomic policies or issues that were identified in the literature survey, as having impacted negatively on South Africa's attractiveness to inflow FDI (thereby leading to the proposed hypotheses), generated results similar to those generated by earlier researchers (as indicated in the literature survey).

### **7.2.3 Policy reforms**

The first hypothesis test was based on possible policy reforms needed to improve South Africa's attractiveness to inflow FDI. The finding of this analysis generated good support for the need to reform the identified policies. The variables tested include the Employment Charter, high interest rates, labour related policies, and income redistribution.

#### **7.2.3.1 Outcome of the finding**

As a backdrop to the findings of this research, drivers of the current inflation rate in South Africa have been identified as the escalating increase in food prices (which rose to 13.5 per cent) and transport (which rose to 12 per cent) in December, 2007.

This research has found that agriculture/agro-processing receives very little investment attention by investors, a situation that is not likely to improve soon. This implies that the current inflation rate (food-related inflation) may not subside any time soon. The impact of fuel-related inflation may also continue for some time, owing to the global increase in commodity prices, especially crude oil. Based on the negative impact of commodity inflation on the real value of money, a further loss of purchasing power in South Africa's small domestic market may further impair the profit motives of MNEs, thereby discouraging inflow FDI.

### **7.2.3.2 Implication**

If the prevailing cycle of ‘uncontrollable’ inflation precipitates a continued hike in interest rates (as is being experienced), this will not only signify instability in the domestic financial market, but also hinder the performance of the domestic financial market, which has been a significant contributor to economic growth. Continued inflation may also further reduce the purchasing power of the domestic market that has been observed to be relatively small in size; all of which discourages inflow (greenfield) FDI.

### **7.2.3.3 Recommendations**

On the one hand, to accommodate the possible shortages in food supply, efforts are needed to boost food production. This may help to ameliorate the food-associated CPIX inflation and its related vicious cycle.

On the other hand, the use of public transport should be encouraged by the government to address fuel-inclined inflation. This could be achieved by improving the quality of service delivery of this sector, ranging from its reliability through to its safety, efficiency and accessibility.

It is observed from this research that efforts to reform the identified macroeconomic policies will help reduce inflation, boost investor confidence, and stimulate inflow (greenfield) FDI to South Africa.

### **7.2.4 Hindrances to South Africa’s attractiveness to inflow FDI**

The analysis of the second hypothesis found that some other factors apart from the needed policy reforms, also contribute to the low attractiveness of South Africa to inflow (greenfield) FDI. The analysis found crime to be the most significant variable in this regard.



#### **7.2.4.1 Outcome of the finding (7.2.4)**

Having singled-out crime as one of the major deterrents to inflow FDI to South Africa (aside the policy reforms identified in hypothesis 1), efforts are required to thwart the purported architects of crime. In addition, the relatively small market size should also be enlarged through a well-focussed policy initiative that redistributes national wealth more equitably.

#### **7.2.4.2 Implication**

Socio-economic stability and environmental peacefulness are always seen as some of the necessary conditions needed to attract inflow (greenfield) FDI. This is mainly attributed to the need by MNEs to protect their employees (both local and expatriates) and investments. South Africa's low rating in this regard has been demonstrated to hinder the attractiveness of the country to inflow (greenfield) FDI.

#### **7.2.4.3 Recommendations**

It may therefore, be suggested that a well-focussed, policy intervention, is required to help reduce crime, thereby improving South Africa's perception as an attractive destination to inflow (greenfield) FDI. Also, the crime rate and its associated vices may be addressed by promoting labour-intensive and export-driven industrialisation, with a thrust that is capable of absorbing some of the unskilled/ unemployed members of society that engage in crime and violence.

#### **7.2.5 Addressing inequalities in South Africa**

Another condensed table (table 35) was constructed to test the possibility of reducing inequality in South Africa as a way of improving the small size of the domestic market. This analysis identified the need to reform the tax system in the country. This is observed to be capable of ensuring income and wealth redistribution.

### **7.2.5.1 Outcome of the finding**

According to the analysis, if tax reform is achieved, crime and violence may decrease, thereby improving the ranking of South Africa's investment climate. This effort may also enlarge the market size by improving the purchasing power of the vast majority, who are financially incapacitated at present, due to 'tax drag' that is occasioned by the inflation. A progressive form of tax system may also lower the cost of living of people, thereby reducing poverty-related crimes and violence.

### **7.2.5.2 Implication**

This finding confirms the identified, technical inadequacies in GEAR, as a macroeconomic policy. It also shows why GEAR is less likely to achieve its purpose of creating an investor-friendly environment, as it has failed to reduce unemployment, poverty, or curb crime. Meanwhile, ASGISA was identified to be capable of addressing some of the shortfalls of GEAR if the necessary support and resources are directed towards such a goal.

## **7.3 Overall summary**

Findings from this empirical survey confirm those of previous research, relating to the attractiveness of countries to inflow FDI, as revealed in the literature survey. It has been established that a country's macroeconomic policies influence its attractiveness for inflow FDI. The impact of South Africa's fiscal, monetary and other investment related policies on its attractiveness to inflow FDI was seen to be vital.

Variables such as tax policy, high interest rates, labour policies (e.g. Employment Equity Acts, BBBEE, Affirmative Action and severance packages), political stability and market size all impact negatively on the attractiveness of South Africa to inflow FDI; and the impact of crime on the country's investment environment is generally

very negative. Both investors and the policy makers agree unanimously that crime is the major deterrent to inflow FDI to South Africa.

Given that the majority of the South African population live in poverty, the vicious cycle of poverty results in social problems that further works against a positive perception rating of South Africa's investment environment. Government's redistribution efforts need to be galvanised and directed to the needy constituencies, towards ameliorating the negative perception of the country by investors.

#### **7.4 General recommendations**

As important as all the variables tested are in relation to the attractiveness of South Africa to inflow FDI, it has been discovered that there is the need to reform some government policies in order to make South Africa more attractive to inflow FDI; amongst which are interest rate policies, tax policies and labour policies.

For instance, the reasons given, inter alia, by multinationals such as Thintana, Lonmin Plc, Daun and Cie Consortium, for divesting from South Africa, are in consonance with the factors identified in this research as having the potential to discouraging inflow FDI.

It has also been established that the most favourable types of inflow FDI to the South African economy, are greenfield and joint venture investments. This suggests that adequate government attention should be directed at incentivising these types of investments, as an intervention towards creating jobs, thereby reducing poverty and its vicious cycle – all of which hinder FDI inflows.

The current interventions and reform programmes initiated by the government, such as the Foreign Investment Grant (FIG), The National Industrial Participation Programme (NIPP), the Motor Industry Development Programme (MIDP), the

Export Marketing And Investment Assistance Scheme (EMIA), the Integrated Manufacturing Strategy (IMS), and the Microeconomic Reform Strategy (MERS), to name but a few, are all appropriate moves in the right direction, but these initiatives should be galvanised, well-directed, and supported with adequate resources.

## **7.5 Overall conclusion**

One conclusion that can be drawn from this research is that South Africa's macroeconomic policies (especially monetary, fiscal and labour related policies) need to be reformed in order to increase inflow FDI to South Africa. The grave impact of crime on the attractiveness of the country to inflow FDI has also been established.

The research has established that tax reforms would help considerably in addressing inequalities in South Africa. These reforms, along with rejuvenated BBBEE, GEAR and ASGISA policy initiatives, would help address the prevalence of inequality and poverty as well as their associated vices like low labour productivity, shortages of skilled labour, socio-political instability, and the AIDS pandemic, all of which have negatively impacted South Africa's ranking as an investment (greenfield FDI) destination.

On the whole, the research has been able to touch on the factors and issues that influence inflow FDI to South Africa (especially the greenfield type of FDI). Further research may be conducted, inter alia, on those elements of macroeconomic policy that are conducive to improving South Africa's ranking as an investment destination.

It is suggested that substantial resources should be allocated for such research (which were the main delimitations of this research), in order to generate more comprehensive response rate.

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**Letter of introduction**

Dear Sir/madam,

I am a Master's Degree student at the University of South Africa, in the department of Business Management- International Business.

My Degree dissertation is focused on discovering the challenges that confront foreign investors in South Africa.

As a part of the research, a questionnaire has been designed for Provincial Organisations (including other relevant government parastatals) that deals with foreign businesses in South Africa.

Your organisation has been selected as one of the targeted respondents in this regard.

Kindly signify your intention to participate so that I can send the questionnaire for completion. It will be sent on-line and the completed copy should also be returned on-line to this e-mail address.

Looking forward to your participation.

Truly yours,  
Aregbeshola R A.

Tel. 073 011 5552

## Appendix 2

### Investors' letter of introduction

Dear Sir/madam,

I am a Master's Degree student at the University of South Africa, in the department of Business Management- International Business.

My Degree dissertation is focused on discovering the challenges that confront foreign investors in South Africa.

As a part of the research, a questionnaire has been designed for international organisations currently operating in South Africa.

Your organisation has been selected as one of the targeted respondents in this regard.

Kindly direct me appropriately on where to direct the questionnaire for completion. It will be sent to you on-line and the completed copy should also be returned on-line to this e-mail address.

Looking forward to your participation.

Truly yours,

Aregbeshola R A.

Tel. 073 011 5552

University of South Africa  
School of Management Sciences

Please, Mark the appropriate box with a cross

X
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**PART A: DETAILS OF RESPONDENT**

Name of Department: \_\_\_\_\_

Contact number of respondent: \_\_\_\_\_

**A1 Current position of respondent**

Chief Executive Officer (CEO)

Director General

Managing Director

Top Management

Other: (Specify, e.g. Head of Dept.).....

1
2
3
4
5

**A2 For how long have you been working for this organisation?**

(The ministry/ dept. as a whole)

Less than one year

Between one and two years

Between three and five years

Between six and ten years

More than ten years

1
2
3
4
5

**PART B INVESTMENT RELATED ISSUES:**

**B1** What specific type of foreign investment do you favour for the South African economy?  
 1=Strongly Disfavour; 2= Disfavour; 3= Favour; 4= Strongly Favour

(a) Mergers and acquisitions	1	2	3	4
(b) Greenfield investments	1	2	3	4
(c) Licensing	1	2	3	4
(d) Joint ventures	1	2	3	4
(e) Strategic alliances	1	2	3	4
(f) Other (specify and rank).....	1	2	3	4

**B2** Why do you prefer the investment in **B1**?  
 1=Not important; 2= Less important; 3= Important; 4= Very Important

(a) Employment effects	1	2	3	4
(b) Export promotion effects	1	2	3	4
(c) Foreign earnings effects	1	2	3	4
(d) Import substitution effects	1	2	3	4
(e) Benefits to other organisations	1	2	3	4
(f) Other (Specify & rank).....	1	2	3	4

**B3** How competitive do you deem the following South African policies to be in terms of attracting FDIs, relate to other developing nations such as India and China?  
 1=Unattractive; 2= Less attractive; 3= Attractive; 4= Very Attractive

(a) Tax holiday/ Provision for depreciation	1	2	3	4
(b) Import substitution strategy	1	2	3	4
(c) Export promotion subsidy	1	2	3	4
(d) Exchange control liberalisation	1	2	3	4
(e) Unrestricted profit remittance	1	2	3	4
(f) Other (Specify and rank).....	1	2	3	4



**B4** Which particular government policy/ issues do you think attracts investors to South Africa?

1= No influence; 2= Less influence, 3= Much influence; 4= Profound Influence

- (a) Investment incentives
- (b) Fiscal policy
- (c) Monetary policy
- (d) Infrastructure
- (e) Market size/ growth potential
- (f) Other (Specify and rank).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B5** What particular problems/ procedures do investors usually complain of at the initial stage of their investments in South Africa?

1=Do not complain at all; 2= Seldom; 3= Sometimes; 4= Frequently

- (a) Too many contact points
- (b) Delay in Registration/ approval
- (c) Too much documentation
- (d) Delay in environmental assessment process
- (e) Strict rules/ bureaucratic process
- (f) Other (Specify and rank).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B6** How important are the following sectors to the South African economy? Please rank the sector that has the highest level of synergy with other sectors.

1=Not important; 2= Least important; 3= Important; 4= Very Important

- (a) Farming/ agro-processing
- (b) Mining
- (c) Manufacturing/ construction
- (d) Financial services/ general consultancy
- (e) Information and communication technology
- (f) Other (Specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B7** Kindly indicate the presence of foreign investors in these industries (kindly rate according to the level of frequency)  
 1=Rarely available; 2= Somewhat available; 3= Available; 4= Very Prominent)

- (a) Information & Comm. Techno.
- (b) Financial & Banking Services
- (c) Manufacturing & Construction
- (d) Farming & Agro-processing
- (e) Marketing & Distribution
- (f) General business services (consultancy)

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B8** Which of the industries above contributes most to the economic growth and development of South Africa? Kindly rank according to their relevance to GEAR and ASGISA Policies.

- (a) Information & Comm. Techno.
- (b) Financial & Banking Services
- (c) Manufacturing & Construction
- (d) Farming & Agro-processing
- (e) Marketing & Distribution
- (f) General business services (consultancy)

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B9** If employment problems are to be addressed, which particular industries need the most incentives?

- (a) Farming/ Agro-processing
- (b) Mining
- (c) Manufacturing/ Construction
- (d) Financial & Business Services
- (e) Information & Comm. Techno.
- (f) Other (Specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B10** Which particular macroeconomic policy do you think hinders the profitability or growth of foreign investments in South Africa?

1= Unimportant; 2= Less important; 3= Important; 4= Very important)

- (a) The GEAR
- (b) Tight fiscal policy
- (c) High interest rates
- (d) Labour related issues/ policies(e.g. the Labour Relations Act)
- (e) Other (Specify and rank).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B11** If you favour policy reform to make South Africa more attractive to foreign investors, which policy do you think needs reform?

1= Not important; 2= Less important; 3= Important; 4= Very Important)

- (a) Broad-Based Empowerment Charters
- (b) High interest rates
- (c) Labour related issues/ policies
- (d) Income redistribution mechanism
- (e) Immigration Acts/ expatriate related policies

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B12** What other issue do you think hinders the flow of FDI to South Africa?

1= Unimportant; 2= Less Important; 3= Important; 4= Very Important)

- (a) Political instability
- (b) Shortage supply of skilled labour
- (c) Relatively small market size
- (d) Crime related issues
- (e) Other (Specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B13** Which of the macroeconomic policies do you think is capable of addressing the inequalities in South Africa?

1=Irrelevant; 2= Over ambitious; 3= Inappropriate; 4= Suitable

(a) Tax policy reforms	1	2	3	4
(b) The GEAR	1	2	3	4
(c) The ASGISA	1	2	3	4
(d) Something new (pls. Specify).....	1	2	3	4

**B14** On the overall as a part of the policy-making organ, what do you think needs to be done to make South Africa more attractive to foreign direct investors?

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**University of South Africa**  
**School of Management Sciences**

Please, mark the appropriate box with a cross  X

**PART A: DETAILS OF RESPONDENT**

Name of Organisation: \_\_\_\_\_

Contact number of respondent: \_\_\_\_\_

**A1 Current position of respondent**

- Chief Executive Officer (CEO)
- Regional Director
- Managing Director
- Top Management
- Divisional Manager

1
2
3
4
5

**A2 Since when have your organisation been operating in S. Africa?**

(This specific organisation)

- Less than one year
- Between one and two years
- Between three and five Years
- Between six and ten Years
- More than ten Years

1
2
3
4
5

**A3 Type of industrial sector** (Dominant industry participation)

**PRIMARY**

Mining

1
---

Farming

2
---

Fishing

3
---

Forestry/ Timbering

4
---

**SECONDARY**

Manufacturing

1
---

Construction

2
---

Assembling

3
---

Export processing

4
---

**TERTIARY**

Business services (e.g. ICT, consultancy)

1
---

Traders (e.g. wholesale, retail)

2
---

Hotels and guesthouses

3
---

Financial services (e.g. banking)

4
---

**A4 Scope of business**

Single-product business

1
---

Dominant-product business

2
---

Multi-product business

3
---

**A5 Size of Organisation**

**NUMBER OF EMPLOYEES**

1-10

11-50

51-100

101-500

More than 500

1
2
3
4
5

**RATE OF TURNOVER (In 2005)**

\$1 000 000 or less

\$1 000 001- \$10 000 000

\$10 000 001- \$50 000 000

\$50 000 001-\$100 000 000

More than \$100 000 000

1
2
3
4
5

**PART B POLICY RELATED ISSUES**

**Please rate according to importance: Tick appropriate box with a cross.**

**B1** To what extent are the following factors considered whenever you want to choose a foreign investment location?

(1=Not considered; 2= Not important; 3= Important; 4= Very important)

- (a) Market size/growth potential
- (b) Access to global markets
- (c) Political stability
- (d) Monetary/fiscal policies
- (e) Others (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B2** How do you rate the following South Africa's trade/ investment policies as compared to other developing nations of the world?

(1= Very Unfavourable; 2= Unfavourable; 3=Favourable; 4= Very Favourable)

(a) Business approval requirements	1	2	3	4
(b) Wholly-owned subsidiary policy	1	2	3	4
(c) Profit remittance policy	1	2	3	4
(d) Local content policy	1	2	3	4
(e) Other (Specify and rate).....	1	2	3	4

**B3** Which of the following political economy of South Africa offers prospects for the profitability and growth for resident investments more than any other developing nations like India or China?

(1= Strongly disagree; 2= Disagree; 3= Agree; 4= Strongly agree)

(a) Political stability	1	2	3	4
(b) Economic growth	1	2	3	4
(c) Socio-cultural considerations	1	2	3	4
(d) Legal frameworks	1	2	3	4
(e) Fiscal and monetary regime	1	2	3	4

**B4** Which particular fiscal/ monetary policy most favours your industry, and specifically your organisation?

(1=Very Unfavourable; 2= Unfavourable; 3= Favourable; 4= Very Favourable)

(a) Tax holidays	1	2	3	4
(b) Provisions for depreciation	1	2	3	4
(c) Import substitution/ restrictions	1	2	3	4
(d) Export subsidies and incentives	1	2	3	4
(e) Other (specify and rate).....	1	2	3	4



**B5** Which particular labour policy in South Africa hinders / aids the attractiveness or performance of your Industry?

(1=Very Unfavourable; 2= Unfavourable; 3= Favourable; 4= Very Favourable)

- (a) Employment Equity Act
- (b) The Broad-Based BEE
- (c) Severance package
- (d) Affirmative action
- (e) Other (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B6** How does your industry react to the following economic/ fiscal policies?

(1=Very Negatively; 2= Negatively; 3= Positively; 4= Very Positively)

- (f) Flexible foreign exchange regime
- (g) Increasing interest rates
- (h) Low inflation rate
- (i) Government budget austerity
- (j) Other (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B7** If you favour any policy reform to make your industry more competitive, which policy needs reform?

(1= Very Unimportant; 2= Unimportant; 3= Important; 4= Very Important)

- (a) Broad-Based Empowerment Charters
- (b) Flexible foreign exchange regime
- (c) Organised Labour Acts
- (d) National bilateral trade agreements
- (e) Other (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B8** What factors/ issues do you think hinders the flow of FDI to South Africa?

(1= Very Unimportant; 2= Unimportant; 3= Important; 4= Very Important)

- (f) Political instability
- (g) Shortage supply of skilled labour
- (h) Relatively small market size
- (i) Crime and corruption
- (j) Other (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B9** On the overall, as an investor in South Africa what perception do you hold of the country's macroeconomic policies and the political ideology of the ruling alliance?

(1= Strongly Disagree; 2= Disagree; 3= Agree; 4= Strongly Agree)

- (a) Stable and favourable
- (b) Unfavourable and volatile
- (c) Unfavourable but stable
- (d) Favourable but unstable
- (e) Unfavourable but promising

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**SCALE for questions B10 and B11**

**1 implies ≤ 10 percent**

**2 implies ≤ 20 percent**

**3 implies ≤ 25 percent**

**4 implies ≥ 35 percent**

**B10** What percentage of your operating costs do you spend on the following?

- Security and crime
- Cost padding (corruption)
- Human capital development
- Corporate social responsibility
- Other (specify and rate).....

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

**B11** Which sector do you plan to expand in line with your growth strategy and what percent of your expansion budget goes to the sector?

Agriculture

1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4
1	2	3	4

Mining

Information technology

Transport

Other (specify and rate).....

**B12** How competitiveness is South Africa as compared to other destinations for foreign direct investments like India and China in terms of growth potentials?

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Reminder letter

Dear Sir/ Madam,

This is a reminder notice to inform you that I am still awaiting your completed questionnaire.

The deadline for final collection is just a few days away and your contribution will greatly enhance the quality of this research.

Please find another attached copy of the questionnaire for your convenience.

Looking forward to your kind support.

Truly yours,

Aregbeshola R A

Letter of appreciation

Dear Sir/ Madam,

I am very grateful for your kind support to have taken time out to participate in this survey.

I thank you so much and wish you the very best in your career endeavour.

Truly yours,

Aregbeshola R A.

Tel. 073 011 5552