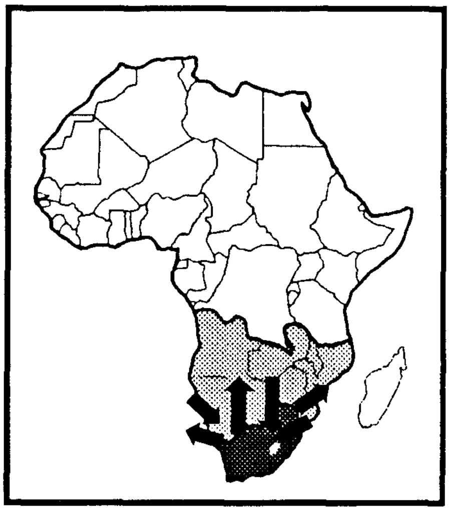
TRADE POLICY DOSSIER



Foreign Direct Investment

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POLICIES TOWARDS INWARD FOREIGN INVESTMENT

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1 BACKGROUND - THE NEED FOR INCREASED INVESTMENT[1]

The aims of any democratic government are best achieved in a growing economy, which in South Africa's case will be fuelled in the first instance by the removal of the costs, the distortions and the inefficiencies caused by apartheid and other discriminatory policies; by the removal of those sanctions imposed by the world against the apartheid regime which have served to prevent or limit economic growth; and by a release and fuller use of the energy and ingenuity of all South Africa's citizens.

But accelerated growth will also require an increase in investment. By far the largest part of this investment should be financed by domestic savings and domestic effort. That is both desirable and necessary. Public sector surpluses and subscriptions to government loans will be needed to finance a broadening of the state's infrastructure. Reinvestment of retained company profits, investments and loans by financial institutions, and the savings of individuals will continue to finance most private sector expansion. Given the importance that is attached to achieving a stable financial framework (e.g. the avoidance of unmanageable budget and balance of payments deficits), these objectives themselves imply recognition of the need to create a political economy in which companies and individuals have both the opportunity to save and the incentive to invest. Out of their growing proportion of national income, an increasing share of those savings and investments will be made by the majority African population.

But there will also be scope and need for some inward foreign investment. It should be the policy to encourage this so long as it occurs on terms consistent with the government's developmental goals. South Africa has abundant natural resources and human potential, but private inward investment will also be needed (a) to augment domestic savings, provided the return on such inward investment is greater than its servicing costs; (b) to introduce state-of-the-art technology; (c) to provide appropriate management skills; and (d) to facilitate access to foreign markets. Foreign investors will be particularly encouraged to invest in activities which lead to increased employment and the development of local technological capacity.

It may also be in the interests of the country for the government to allow outward productive investment by South African companies in circumstances which will lead to the expansion of trade. The opportunities for intra-African trade are especially attractive.

2 CHANGING ATTITUDES TOWARDS INWARD FOREIGN INVESTMENT

Over the last decade there has been a marked change in the attitude of most developing countries to foreign direct investment and to the role of transnational corporations (TNCs) in the investment process. Until the tide began to turn in the second half of the 1970s there had been a period of confrontation in which the relations between host countries and TNCs had rapidly deteriorated. The build up to a confrontation coincided with the emergence of a number of developing countries from colonial status, and world wide there was a disposition to ask critical questions about the role of TNCs. In some countries the activities of TNCs were seen as a threat or potential threat to sovereignty and throughout the developing world there was much scepticism about the benefits of foreign direct investment. These negative perceptions were particularly evident in the context of natural resource projects. The old style concessions often granted in a colonial or neo-colonial setting, and sometimes in very dubious circumstances, seemed to many developing countries to have deprived them of a significant part of their patrimony.

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[1] This article is based upon a study that was commissioned at the request of the African National Congress (COSATU), and funded by the United Nations Centre on Transnational Corporations (UNCTC).

The mood today is very different and changing attitudes had become very apparent long before the collapse of the command economies of Eastern Europe and the Soviet Union. In many developing countries there is still a good deal of wary scepticism about the benefits of foreign investment, but most of the tension has gone out of the relationship between host countries and TNCs. Not many developing countries would now see the activities of TNCs as a threat to their sovereignty, or to their growth potential. The influence of TNCs on international economic activity has indeed grown to be very great but it is an influence not generally exerted over or on behalf of any single national government, but rather according to its own logic. Countries with particular resource endowments in terms of labour, skills, natural resources or even location have been able to take advantage of TNC investments to increase employment, exports and government revenues, to improve living standards, and even to enhance their own national economic power. In particular TNC inward investment, correctly handled, has proven to be an effective way of enhancing domestic management capacity and technological skills. There are, of course, continuing areas of concern, in particular with regard to the labour practices of some of the 'footloose' industries and to the ability of TNCs to concentrate their profits in low-tax havens through transfer pricing and other equivalent practices. But, taking a broad perspective, by and large the worst fears that newly independent governments had concerning the threats that inward direct investment would pose to their sovereignty or their ability to implement their own preferred economic policies have proven to be ungrounded, and there is certainly now a new and more pragmatic approach.

The present climate of received economic opinion stresses the benefits of inward foreign investment and in particular of equity investment which does not create loan servicing obligations. With the globalization of production in the world economy and the integration of capital markets, the case for equity investment has indeed become stronger, providing that such investment is positive in terms of foreign exchange and is internationally competitive. These latter provisos are very important. Capital-intensive investment whose primary objective is to take advantage of high tariff protection in domestic markets may actually reduce income in the recipient country. But the better way to safeguard an economy against such negative effects is now deemed to be by implementing a sound trade policy (i.e. by maintaining a competitive exchange rate and avoiding excessive levels of effective protection) rather than by attempting to regulate too precisely inward flows of foreign investment.

3 THE SPECIAL CASE OF SOUTH AFRICA

Any government considering a regime for foreign investment and looking at the experience of other countries needs to start that process by taking a good look at itself. There are certain special features of the situation in South Africa and of the South African economy which need to be kept in mind.

1 South Africa's economy is large, complex and many sided. It covers manufacturing, the exploitation of natural resources most notably in the mining industry and the provision of a wide range of services including financial services.

2 Existing investment in South Africa includes foreign investment but is predominantly of local origin.

3 There is in South Africa a remarkable concentration of economic power in the hands of a very small number of corporate players who control diffuse but extremely powerful conglomerate groups. Because of the distortions introduced into South Africa by the apartheid system it cannot be assumed that protecting that group from competition from outside investors will confer any benefit on Black South Africans, the dispossessed of the Apartheid era.

4 Outside the mining sector relatively few South African firms are internationally competitive despite the fact that by comparison with neighbouring countries, South Africa possesses considerable technological skills.

5 South Africa has a sophisticated legal structure which has served an active and growing business sector for over a hundred years. Parts of that system may be in need of reform but the framework and building blocks are already in place on site.

6 Post apartheid South Africa will be engaged in a process of change which may aptly be described as revolutionary. The changes that have to be made in order to ensure a more just and humane society will affect every aspect of South African life, and no individual or company will be able to stand back from the process or refuse to participate. For business ANC's commitment to affirmative action will

certainly impose a new range of obligations, and there will be new laws dealing with employment practices, with housing, with training, with trade union rights, with the rights of women, with access to land and with the impact on the environment of manufacturing and mining operations. Foreign investors will be subject like everyone else to this new dispensation, and will not expect to have exemptions, or be permitted to assume a posture of detached indifference. However, it would not be realistic to envisage that a Foreign Investment Code will be at the leading edge of structural change in South African society.

4 THE GENERAL CASE FOR AN OPEN POLICY WITH SAFEGUARDS

One starting point is to say that, subject to a few special exceptions, all foreign investment is welcome without a process of prior approval. Foreign investors will get national treatment. They will enjoy the same rights and be subject to the same obligations as a national engaged in similar activity. With regard to foreign exchange remittances the foreign investor in this category will, for better or worse, have to live with the regime which the Central Bank may ordain from time to time.

Most countries which adopt an open policy give themselves scope for some reservations. Although the cornerstone of the policy may be an open house it is usual to find that there are some exceptions and the code will give the Minister power to exclude foreign investors from participating in certain activities. In Namibia, which enacted a new investment code in December 1990, there was concern that some very small investments might be made by foreigners in businesses which could perfectly well be carried on by Namibians who might not have many other opportunities. (Hairdressing and retail trading were mentioned in the policy statement.) In other countries a ring has been drawn around financial institutions and in others, around participation in defence industries or in the media.

In almost all countries there are special scrutiny and approval procedures which apply to investments in certain sectors whether they are made by locals or by foreigners. Most important in that respect, particularly for South Africa, is the natural resources sector - mining, petroleum, forestry and fishing. With mining, for example, one finds that outside the United States of America minerals in the ground are normally the property of the State and no one can prospect for minerals or mine without the grant of a licence. In contemporary practice a prospecting licence will not be granted except in return for a substantial commitment to an exploration work programme and minimum expenditures. These matters are therefore normally for negotiation between the government and the mining companies, and mining laws have their own built-in approval procedures. The grant of fishing or of felling licenses will be subject to similar regulation and procedures.

Most governments recognize however that national treatment may not always be sufficient to attract foreign investors interested in major projects, and in the type of regime we are now looking at a special status may be offered to investments which have been submitted for scrutiny and approval. An investment which is approved will then be entitled to the benefit of certain guarantees and may also be entitled to a range of fiscal incentives - tax holidays, accelerated depreciation, unlimited loss carry forward and so on.

National treatment offered to foreign investors implies that the foreign investor will in all respects abide by the local law. In an emergent South Africa that will be especially important where new laws and regulations will be a key element in the dynamics of post apartheid change.

5 THE BASICS OF A POLICY TOWARDS INWARD INVESTMENT

Inward private investment is seen as playing an important role in diffusing the present concentration of ownership in South African industry, in modernizing production methods, in improving competitiveness and in providing opportunities for emerging African businesses and managers. Obligations should apply in respect of training, trade union recognition, fair working practices, the need for affirmative action, attention to environmental protection and other matters, but these will be no different from those applying to domestic businesses. The experience of South East Asia has been that the more foreign capital and the more foreign managers and experts come in, and the more they interact with nationals of the recipient country, the quicker these nationals have learnt. Within a generation they become able not only to work alongside the foreign experts but to export their own management and technical skills.

Inward investors wishing to bring capital into South Africa for either direct or portfolio investment should not normally be subject to any restrictions or be entitled to any privileges other than those applying to domestic private investors. The intention should be to encourage and welcome such foreign investment on the same terms and conditions as will be available to domestic investors. The scope for such foreign investment should be limited only in respect of certain specified sectors, which will be publicized in advance and which may be expected to include activities which impinge upon public security, mass communications, and access to certain types of classified land.

There should also be an opportunity for foreign investors contemplating bringing in more than the equivalent of $1 million towards directly productive forms of investment to apply to have such investment registered as 'Special Status Investments'. Such 'Special Status Investments' will enjoy certain exceptional guarantees mainly in regard to the expatriation of foreign exchange but may also be made subject to a commitment to special obligations on the part of the investor. (The Appendix provides a summary of the key elements relating to Special Status Investments.)

Inward portfolio investment should also be welcomed since this will tend to increase the resources available to finance industrial expansion and may also lead to a diversification in the concentration of ownership. In general, however, foreign shareholders making portfolio investments should not be treated any more favourably, or any less favourably, than domestic shareholders.

6 MEASURES TO PROMOTE AND PROTECT NEW LOCAL BUSINESSES

To be appropriate for a democratic South Africa with a thriving 'mixed economy' any investment policy will have to take cognizance of the special position of members of previously disadvantaged groups who will be wanting to start their own businesses. Such persons will require special assistance in terms of training, commercial support, access to capital and in other ways, and may also require a measure of protection against early competition.

For many aspiring Black businessmen and businesswomen, the problem will be how to get started - how to find a place and to break into the established ord of production and trade. The changing pattern demand that will follow a changing distribution disposable income is one factor that should make tl process easier. Special facilities for the encourag ment and support of small businesses (such extension services and venture capital facilities) wi be another. A limited influx of outside entrepre neurs bringing in capital and a culture that is diffe ent from that which has hitherto prevailed in whit South African business circles should also help bot by providing opportunities for black businesses t form joint ventures with such newcomers and b expanding the demand for such goods and services as a small business will often be in the best positio to supply. The influx of such smaller entrepreneur not being offered special privileges does need to b limited and controlled, however, because certai categories of such people may be professional practi tioners, technicians or tradesmen specializing i precisely those areas of work which hitherto under privileged South Africans will themselves be aspiring to move into. The most appropriate way to deal with this problem will not in general be by legislating against or restricting the influx of foreign capital as such, but through carefully drawn and administered immigration controls. The existence of the problem does however suggest that there will need to be a certain minimum sum derived from their own resources that all immigrants intending to start a business will be required to show that they will be bringing into the country before being granted the required work permit or immigrant's visa.

There is one important financial restriction which would not apply to domestic investors but which should remain in force for foreign investors. It is common for governments to place restrictions on the local borrowings of companies that are owned or controlled by non-residents, or in which non-residents own a significant shareholding. The purpose of such a restriction is to ensure proper capitalization of foreign investments. Where local borrowing facilities are available to such companies, approval may also be required before profits and dividends are remitted abroad. The promulgation of such regulations are normally the responsibility of the Central Bank, as are the issues of any necessary approvals or authorizations, but it is normal for a Foreign Investment Code to refer to the existence of such restrictions, and we would expect this to be the case in respect of any future South African investment code.

7 SPECIAL REQUIREMENTS OF FOREIGN INVESTORS

Much the most important requirements in practice for most foreign investors are guarantees relating to foreign exchange. The foreign investor needs to feel confident that foreign exchange will be available:

1 to pay for the imports necessary to keep the business going and, when necessary, for professional advice and technical assistance;

2 in the case of loans in foreign exchange approved by the Central Bank to repay the principal sum due and to pay interest and service charges as they fall due;

3 to pay licence fees and royalties due to persons resident outside the host country, subject to such constraints as may be imposed under legislation dealing with the transfer of technology;

4 to transfer after tax profits to shareholders in the form of dividends, or, in the case of companies incorporated abroad and carrying on branch operations, to make remittances to head office out of funds representing after tax profits;

5 where there has been a sale of the investment to a resident of the host country or a reduction of the share capital, to repatriate the proceeds.

A second important matter upon which a foreign investor may require assurance concerns security of title. A post-apartheid government in South Africa will certainly want to reserve to itself the right to take existing investments into public ownership. No doubt the constitution will provide for the payment of compensation for expropriated assets. However against a background of far reaching structural change it must be anticipated that foreign investors will be sensitive to the political risk factor and concerned in particular with the possibility of expropriation.

From the standpoint of a foreign investor the optimum solution in the context of an approved investment would be for the Certificate of Approval to incorporate a guarantee that the investment will not be expropriated. If that is not possible most investors would attach considerable importance to a guarantee that in the event of expropriation the amount of compensation and the manner of payment could be referred for final determination to international arbitration.

With respect to general fiscal incentives, a number of developing countries have sought to attract foreign investment by offering to approved investments a range of fiscal concessions - tax holiday, accelerated depreciation, unlimited loss carry forward, uplift on capital allowances etc. In some instances governments may see concessions as necessary in order to offset the negative effect of unusually high rates of tax which could make a particular fiscal regime uncompetitive by international standards. Other governments offering guarantees to approved investors have rejected the idea of fiscal incentives set out in a Code. Where the generally applicable rate of tax is reasonable, across-the-board incentives are seen as wasteful and unnecessary.

There are a number of reasons for rejecting the inclusion of across-the-board incentives.

1 In order to create stable conditions for economic growth, a government needs a broad revenue base which is not continuously eroded by piecemeal concessions;

2 Tax concessions may be wasteful since in many cases, if other conditions are satisfactory, such concessions will not be needed in order to attract foreign investment;

3 Double Taxation Treaties, and the unilateral double taxation relief offered by many capital exporting countries, mean that the practical effect of tax holidays is often uncertain;

4 Where in a particular sector, or in a particular region, or in connection with some particular activity, it is adjudged that a fiscal concession is required in order to attract investment, appropriate provision can be made by amendment to the existing law, which may then apply alike to both foreign and domestic investors.

In South Africa this last point is particularly important. Particular industries (such as 'high tech' industries), particular sectors or particular regions may require special treatment in order to attract investment. Likewise it may be considered desirable to encourage particular exports or specific forms of efficient import substitution. Provision for that can be made as an act of deliberate policy or in consequence of a particular negotiation either in the tax laws or through other financing arrangements without conferring benefits or foregoing revenue when it is not necessary to do so.

8 THE ROLE OF A FOREIGN INVESTMENT CODE

The role of a foreign investment code is two-fold. First, it should be a vehicle for indicating and publicizing which particular categories of investment are to be favoured with special concessions and which are prohibited for foreign investors. Second, it should serve to counteract certain of the particular disadvantages that the foreign investor may labour under by comparison with the domestic investor.

These particular disadvantages are normally:-

1 the potential foreign investor may be less fully informed than the domestic investor;

2 the potential foreign investor may find it more difficult to apply for and receive the necessary consents and licenses needed before he or she can start business - although it is not anticipated that these will normally be any different than they will be for a domestic investor;

3 while the domestic investor will normally be content to receive profits, dividends, interest payments etc. in domestic currency, the foreign investor will be concerned at his or her ability to convert at least a proportion of them into foreign exchange and to repatriate capital also in the event that he or she wishes to wind up or dispose of the business;

4 in the event of nationalization, or of certain other types of dispute arising, the foreign investor may feel that as a foreigner he or she may be discriminated against by the host government or be at a disadvantage in the local courts.

Although a foreign investment code can be useful in stimulating and guiding inward foreign investment, its potential influence is limited and its effect will always be subsidiary to that of other factors. Amongst such other factors the mo important are:-

1 the opportunity which the investor sees for mal ing a profit and for enjoying the fruits of that profi

2 the track record of the government in question i dealing with earlier foreign investment;

3 how the government of the day treats the firms an individuals in the country's own private sector.

Experience strongly suggests that if these factor are perceived to be favourable, foreign investor will seek to come whether or not there is a foreigr investment code. If they are absent, investors wil shy away however invitingly generous the provisions of a code may appear to be. This being so, tax holidays and exceptional capital write-offs (i.e. provisions more generous than those allowed to domestic investors) are as often as not simply a means of diminishing government revenues from an investment that would have been made anyway, or of favouring foreign investors over domestic investors, or of influencing an investment in favour of capital-intensive rather than labour-intensive techniques. If rapid capital write-downs are desirable to encourage certain types of major investments - as indeed they may be - such accelerated write-downs should be made equally available to domestic investors who can then decide for themselves whether, and in what form, to bring in foreign capital.

In short, a future South African government should generally be neutral in any measures intended to induce investment, foreign or domestic. Where tax legislation (or specific government expenditures) do favour one category of investor over another, that preference should be deliberately exercised either in favour of particular types of investment that are considered specially desirable, or in favour of particular under-developed regions, or in favour of those South African citizens who have hitherto been disadvantaged and who will need special measures to assist them to become owners, either directly or indirectly, of a significantly larger proportion of the country's productive assets.

APPENDIX

SUMMARY OF KEY ELEMENTS RELATING TO SPECIAL STATUS INVESTMENTS

1 A foreign investor whose investment was eligible for special status could apply to the Minister for a Certificate of Approval. In considering whether a Certificate should be issued the Minister would have regard to the extent to which the enterprise would -

a increase employment opportunities;

b provide training for South Africans and promote the spread of high level technical skills;

c earn or save foreign exchange;

d generate development in the less developed areas;

e contribute to the transfer of technology;

f contribute to the advancement of persons within South Africa who have been socially, economically or educationally disadvantaged by past discriminatory laws and practices;

g make provision for equal opportunities for women;

h perform activities that would be likely to have an impact on the environment and, where necessary, take appropriate measures to deal with any adverse environmental consequences.

2 Special Status for a foreign investment would not be available:-

a for investments where capital expenditure fell below a minimum figure, or

b for portfolio investments.

3 The issue of a Certificate of Approval for a Special Status Investment will be within the discretion of the Minister, and when issued the Certificate will specify the conditions on which approval has been given.

4 The holder of a Certificate of Approval for a Special Status Investment will enjoy certain guarantees:-

A GUARANTEES IN RESPECT OF FOREIGN EXCHANGE

The holder of a Certificate will be given an undertaking that foreign exchange will be available:-

a to enable the investor in the case of loans in foreign exchange approved by the Reserve Bank to repay the principal, interest and service charges as they fall due;

b to transfer dividends to shareholders resident outside South Africa, or where the business is carried on as a branch operation of a foreign company to make remittances to head office;

c to pay licence fees and royalties due to persons resident outside South Africa, where such payments are made under approved rules;

d in the event of the sale of a Special Status Investment or part of it, or in the event of a reduction of capital, to repatriate the proceeds; the Reserve Bank would however retain the right to require that where amounts are large transfers should be scheduled over a period of time;

In the case of a business producing for export, where the Certificate so provided, the holder could be allowed to retain off-shore the proceeds of sale after remitting sums required to meet taxes and other local obligations.

B GUARANTEE RELATING TO NATIONALIZATION

A new constitution will provide in some acceptable form for the payment of compensation for assets taken into public ownership. In the event of a dispute between Government and the holder of a Certificate of Approval concerning the amount of compensation due, or about the manner of payment, the Code would provide that the dispute could at the instance of the investor be referred to international arbitration.

5 The Certificate of Approval would remain in force only so long as the investor complies with certain reciprocal obligations. There would be two basic requirements:-

a Every investor seeking a Certificate of Approval would be required to make specific proposals for training which, once agreed, would be incorporated in the Certificate as a condition of approval. Failure to comply with the condition could lead to cancellation of the Certificate;

b Proposals of the investor relating to the investment itself would be incorporated in the Certificate and would constitute binding commitments. Failure to honour those commitments could jeopardise the continued validity of the Certificate.

6 In the event of a dispute between the Government and the holder of a Certificate of Approval about the continued validity of the Certificate, if the dispute could not be settled by agreement, it could at the instance of the investor be referred to international arbitration.

COSATU

Platform of Guiding Principles for Foreign Investors

The following principles for foreign investors were drafted by the African National Congress and the Cosatu trade union federation and approved by the "National Conference in Support of the African National Congress and Other Democratic Forces for a New South Africa" held in New York City on Nov. 13-15, 1992.

INTRODUCTION

The apartheid legislative process that governs investment at present is a major obstacle to growth and development. In this context the process of foreign investment needs to be assessed with care.

At present the basic ILO Conventions do not apply across South Africa. Discriminatory practices are widespread, and the lack of transparency in government is hiding corruption and inefficiency, and promoting political violence and destabilization. Measures to protect the environment are weak, weakly implemented or non-existent. Investment in such a context will, therefore, not automatically contribute to growth, development or the eradication of apartheid.

GUIDING PRINCIPLES

We therefore propose that any investment after the lifting of the policy of economic sanctions should be guided by the following principles:

1) Companies should uphold **workers' rights** including the recognition of representative unions and their rights to bargain collectively, to strike, to picket peacefully, and strike breakers will not be hired.
2) Investment should enhance **employment creation**.
3) Companies will eliminate all discrimination on the basis of race, religion, sex, political opinion or physical handicap and will implement **affirmative action** programs.
4) Investment must incorporate **environmentally sound** and clean practices and technology.
5) Investment should enhance the productive capacities of South Africans, and should, in particular, institute **training and adult education programs** for workers in consultation with the trade union movement.
6) **Conditions of work and life** offered by companies shall compare favorably with the best conditions in the relevant sector domestically.
7) Investment should contribute to the **security of employment** of South Africans.
8) Companies should, where possible, adopt business practices which enhance the **development of black business** in South Africa.
9) Mechanisms should be put in place to evaluate the **implementation** of the above principles, including the disclosure of relevant information by companies.

FUTURE POLICIES OF A DEMOCRATIC GOVERNMENT

It is our intention to have the above principles incorporated in the future policies and laws of a democratic government, and these will apply to all investors, domestic or foreign. In the interim phase, we will campaign for these principles, and will support the further development of codes of conduct along with other democratic formations.

SA Council of Churches

Text of the New South African Code for Business

The South African Council of Churches July 8 approved the following code of conduct for business operating in South Africa.

1. **Equal Opportunity:** Companies should insure that their operations are free from discrimination based on race, sex, religion, political opinion or physical handicap, and implement affirmative action programs designed to protect the equal rights and treatment of the historically disadvantaged.

2. **Training and Education:** Companies should develop and implement training and education programs to increase the productive capacities of their South African employees in consultation with the trade union movement.

3. **Workers' Rights:** Companies should recognize representative unions and uphold their employees' rights to organize openly, bargain collectively, picket peacefully and strike without intimidation or harassment.

4. **Working and Living Conditions:** Companies should maintain a safe and healthy work environment and strive to ensure that the working and living conditions they provide accord with relevant international conventions.

5. **Job Creation and Security:** Companies should strive to maintain productive employment opportunities and create new jobs for South Africans.

6. **Community Relations:** Companies should share information about their practices and projected plans with communities affected by their operations, and develop social responsibility programs in ongoing consultation with representatiive bodies in these communities.

7. **Consumer Protection:** Companies should inform consumers of any possible dangers associated with their products and cooperate with consumer protection and broader community organizations to develop and uphold appropriate product safety and quality standards.

8. **Environmental Protection:** Companies should utilize environmentally sound practices and technologies, disclose how and in what amounts they dispose of their waste products, and seek to minimize hazardous waste.

9. **Empowerment of Black Businesses:** Companies should strive to improve the development of black-owned South African businesses by purchasing from and sub-contracting to such firms.

10. **Implementation:** Companies should cooperate with monitors established to implement these standards by disclosing relevant information in a timely fashion.

MERG/COSATU Background paper for the
National Economic Forum
Long-Term Working Group

HOW TO ATTRACT FOREIGN INVESTMENT

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Why do we need foreign investment? We need foreign investment in South Africa in so far as it can contribute to the primary goals of economic policy: to create jobs, and to improve the quality of life of the population as a whole, especially the very poor. While some may feel that not all foreign investments contribute positively in these two respects[1], analysts generally agree that foreign investment can contribute to economic development. This paper initially considers some of the most important the potential positive effects of **foreign direct investment** (FDI) in South Africa, and the ways to maximise them. It then considers policies to counteract the factors discouraging foreign investment and strengthen positive factors. It addresses the question of financial incentives, and, finally, the issue of politics.

1 Why do we need inward direct foreign investment?

1.1 Investment capital

It might be argued that the investment crisis in South Africa — what some call the 'investment strike' — is the main reason for attracting foreign investment. We do have very low levels of new investment. All analysts agree that investment has been extremely low in South Africa for at least a decade, and that gross fixed domestic investment has declined in all sectors of the economy except for mining and the private service sector.[2] An IMF report suggests that South Africa's investment-to-GDP ratio needs to rise from 19 percent to 27 percent to stimulate adequate growth.[3] Clearly foreign investment can help address this.

But the main reason for the investment crisis is not an overall lack of funds. If contractual savings are included, total domestic savings have been high enough to finance productive investment that has not happened; the primary reason for the investment strike is that potential investors, domestic and foreign, lack confidence in the domestic economy.[4]

In situations of political uncertainty, foreign investors look to potential domestic investors for the signal to invest.

- Therefore the first step towards encouraging foreign investment is the creation of a climate which encourages and stimulates domestic investment.

Foreign investors do not necessarily bring in a great deal of investment capital. Foreign investors generally raise as much investment funds as possible in the markets of the host country.[5] In some developing countries this could give rise to fears that local borrowers might be crowded out of capital markets, though in South Africa's case, with its extensive, sophisticated capital markets, this is unlikely to be a critical issue.

For these reasons, however, the investment funds argument for foreign investment needs to be evaluated more carefully than it often is.

1.2 Balance of Payments

Perhaps a more critical contribution foreign investment can make is in providing foreign exchange. When South Africa begins to grow again, it will face enormous pressures on its foreign payments balance. In recent years we have been forced to maintain a surplus on the trade account of the balance of payments to finance the large net outflow on the capital account of the balance of payments. As a result growth has been constrained.

In the past when South Africa has grown, we have experienced a deficit on the trade account of the balance of payments, financed by an inflow of foreign funds. The main reason for this pattern was that most capital goods which are bought during investment booms in South Africa are made abroad. If we study current supply patterns in the capital goods sector we will find that South Africa is even more dependent on imported capital goods today than we were twenty years ago. This is strongly suggested by the time-series data on industrial development issued by the IDC.[6]

In other words, in order to grow, we will need a great deal of foreign exchange to finance the purchase of capital goods, or to develop the expertise to make those capital goods. There are several important ways of addressing this problem, but one critical component will be the inflow of foreign investment.

However, a recent United Nations report warns against attempts to attract large volumes of foreign investment simply in order to address payments concerns:

> '... the **quality** of foreign direct investment is crucially relevant to host developing countries; they should not, therefore, become over-motivated by apparent short-term **quantity** needs reflecting concerns regarding balance of payments and debt burden. Indeed, with respect to issues relating to debt-service, an aspect of **quality** should be that foreign direct investment should support the structural adjustment needed to facilitate this.'[7]

- In short, we need to make a special effort to attract the kind of foreign investment that will strengthen our competitiveness in the long-term.

1.3 Technology

Because we have invested so little in recent years, because our economy has been somewhat isolated from the world economy for various reasons, and because of our very poor educational system, we have fallen behind our potential competitors as far as technological capacity is concerned. A visit by the Japanese business federation, the Keidanren, in 1991, found a 'technological vacuum' in the South African economy.[8]

There are various ways of addressing this problem, and we need a multi-faceted approach. South Africa urgently needs better education and training, and we must develop domestic technologies, where appropriate.

We can obtain some technologies from abroad in an 'unpackaged form' (i.e. local firms can buy technology), which was the course followed by India and, with greater success, South Korea, until recently.

However, in today's world, transnational corporations (TNCs), which develop a vast proportion of new technologies, are trying harder than ever before to restrict access to those technologies. Moves to protect 'intellectual property rights' within the Uruguay Round of the GATT, for example, reflect the desire of TNCs to exploit the fruits of their research and development more effectively.

- For this reason, we must entice those TNCs which develop technologies relevant to our growth strategy to invest in South Africa.

Some development economists argue that TNCs located in developing countries usually transmit 'the results of innovation, not the innovative process itself', and that 'a strong foreign presence with advanced technology can prevent local competitors form developing their own capabilities'.[9] But this is particularly true for weak developing economies with relatively little capacity to absorb technologies. Evidence suggests that stronger developing countries with pro-active programmes to develop domestic technological capacity can strengthen their technological capacity through encouraging appropriate TNC investment.[10]

- Therefore, we should encourage technologically advanced TNCs to train South Africans to use the new technologies, and to transfer those technologies in other ways. We should also attempt to encourage these firms to locate some of their research and development activities within South Africa.

1.4 Access to markets

One of the most crucial elements of a long-term growth strategy for South Africa is the expansion of exports, particularly the export of higher value added products. The urgent need for structural adjustment in this direction is predicated on the declining relative value of our traditional raw material exports, and their poor longer-term prospects.[11]

The link between foreign investment and exports is twofold.

The first is obvious: South Africa needs the funds and technology that foreign investors can provide in order to be able to make more exportable products. The American experience of recent years serves as an example of the important role of transnational corporations in international trade. In 1988, 80 percent of US trade was undertaken by TNCs.[12]

The second link is more subtle, and perhaps more crucial. A rapidly rising proportion of world trade now takes place within companies — as 'intra-firm trade'. In 1988 more than a third of United State trade represented intra-firm transactions, between foreign affiliates and their parent corporations.[13]

Whether or not South Africa becomes a net gainer in terms of trade by and within TNCs depends on the partly on the competitiveness of the domestic economy, and partly on government policies, particularly with respect to trade and industrial policies. But, without the TNC channel for trade, options are more limited.

1.5 Competition for domestic oligopolies

Another reason for welcoming foreign investment is to provide competition for domestic firms which have become too powerful to allow domestic competition, but use their power to exploit South African consumers. In a sense this runs against the grain of received wisdom which associates TNC investments with monopolistic or oligopolistic markets. Indeed, several investigations into new investment by foreign TNCs follow such a pattern, such as the mooted link up of Heinz with Fedfood.

- A policy initiative to attract foreign investment should be linked to a more coherent competitions policy, with more teeth than current competitions policy, and it should also be linked to a programme which promotes black business (see below).

2 The prospects of inward foreign direct investment

Throughout the course of the 1980s, world foreign direct investment (FDI) expanded more quickly than world trade, which, itself was expanding rapidly. This should have been good news for developing countries[14], but it was not. From the early 1980s to the late 1980s developing countries' share in FDI flows declined from 25 percent to 18 percent. A rising proportion of FDI was taking place between the three legs of the Triad: North America, Europe, and the Japanese area of influence. Moreover, flows to developing countries were highly concentrated, with 10 countries accounting for threequarters of total inflows to developing countries.[15]

Moreover, Africa's share of FDI inflows declined from three percent of all inflows during the 1970s to two percent in the late 1980s.

While present levels of FDI in Eastern and Central Europe remain relatively low, the U.N. estimates that cumulative FDI in those countries could rise to $75-$100 billion dollars by the late 1990s, compared with $9 billion by mid-1991. That suggests average annual FDI inflows of about $10 billion; compare this with $2,2 billion for the whole of Africa in 1990.[16]

South Africa experienced a decline in the share of average annual FDI inflows on gross domestic capital formation from 0,8 percent in the period 1980-82 to -1,4 percent in the period 1985-87.[17] This was one of the worst performances in the world, and can be explained, at least partially, in terms of sanctions pressures. But note that the 0.8 percent in the early period was already much lower than most other developed and developing economies — which should remind us that sanctions did not cause the economic crisis.

- Increased competition for foreign investment means that South Africa needs an appropriate effort to attract foreign investors.

3 Factors negatively affecting foreign investment

However, in spite of our gloomy performance and the apparent marginalisation of Africa, South Africa's recent FDI trends need not necessarily continue unchanged. One crucial question here is what might attract foreign investors to South Africa, and what is keeping them away. A recent survey by a World Bank consultant, WW Schneidman, found that the most critical factors keeping firms away from South Africa were political instability and violence, and uncertainty about the possible economic policies of a future government. Schneidman found that foreign firms do not fear redistribution as such. In fact, one American interviewee noted that redistribution would be welcomed if it were to increase black consumer power; 'The question in many respects is: will redistribution be achieved through taxation, nationalisation, or some other strategy'.[18] Also delaying firms is the legacy of sanctions campaigns.

Another important disincentive to new foreign investment was the quality, cost, and productivity of the South African labour force.

- The chief policy priorities to counteract the negatives are, therefore:

    1) a stable, democratic political settlement;

    2) consistent, credible economic policies, rooted in a broad national consensus;

    3) a firm commitment to training and labour market policies that will

improve labour productivity;

4) the conveyance of a clear message to foreign investors that South Africa will welcome foreign investment. The transitional political period will be an ideal opportunity for marketing South Africa.

4 Positive factors for foreign investment

There are several important incentives to foreign investment that could locate South Africa near the front of the developing country queue for foreign investment. These include the country's sound financial structures and policies, the excellent physical infrastructure, and, most importantly, the size and potential of the consumer market.

One investment analyst has estimated that South Africa has the largest consumer market in Africa. Moreover, the consumer market has still greater potential if the markets of regional neighbours are included. But the extent of investment would be limited at first, with non-equity forms of involvement (e.g. licences and franchises) being potentially more significant during the early periods of transition.[19]

- Therefore, the physical infrastructure, sound financial policies, and the consumer market should be protected and nurtured to encourage new foreign investment.

Several important contemporary characteristics of FDI indicate positively for investment prospects in the medium-term. The international diffusion of innovative activity and of standardised technologies, combined with the regionalization of markets, point to Southern Africa's potential to attract TNC activity on a regional basis. TNCs are, more than ever before, developing worldwide strategies *on a regional basis*, and are devolving more important activities to regional operations. Southern Africa could be the kind of region to attract the serious attention of TNCs with an eye for the local market, and to potential exports further afield.
Or, South Africa could become part of 'regional core networks' for TNCs based in Europe. Regional core networks are 'regionally integrated, independently sustainable networks of overseas investments centred on a triad member'.[20] It is noticeable that Japanese firms investigating investment possibilities in South Africa today, often conduct their investigations out of their European offices.

The diffusion of communications has decreased the economic distance between countries making new kinds of overseas activities more feasible than before.

- Therefore, South Africa should strive to strengthen its claims as a home for the regional bases of TNCs.

The way that Southern African economic integration is approached, and the way trade relations between the region and the rest of the world, starting with the EC, are restructured, could have an important bearing on the regional prospects for FDI, and the regional rewards from that FDI. This particularly important in a world where the competition for investment finds is tougher than ever before.

- Therefore, South Africa should pursue regional integration in such a way that strengthens the regional market.

5 The question of tax incentives

One of the most discussed and least understood issues in the contemporary economic debate is the role of taxation policies in attracting foreign direct investment. It is often claimed that in order to attract new foreign investment South Africa should lower its corporate tax rate, offer tax holidays or other fiscal incentives. Accepting that the objective of government should be reasonably low corporate tax rates, the evidence suggests that basing a foreign investment strategy on low taxes or tax holidays is at best an oversimplification, and at worst, misleading.

Several recent studies of the issue indicate that for most potential direct foreign investors, fiscal incentives have played little, if any, positive role.[21] Tax incentives can influence locational decisions for TNCs that are seeking an export platform when the different locations under consideration are roughly equal in terms of other criteria. But when the foreign investor is attracted by the home or regional market offered by the host country, or by access to natural resources, **generalised** fiscal incentive packages are of little significance (except when one country is competing against another for investment within a common market).

An authoritative survey of studies on the determinants of foreign investment notes that analyses of the issue indicate that:

> '... the traditional investment packages may have had compromising effects in terms of both the **efficiency** of investments stimulated and the **distribution** of benefits generated. **Quantitatively** it is a familiar suspicion that individual countries have paid too much (for example, in terms of forgone tax revenue) for too little stimulus to investment flows, whilst qualitatively it is alleged that the emphasis on cheapening of capital has led to 'inappropriate' operations in countries where employment generation is the more relevant basis of industrialization. Surveys and other evidence indicate that the sensitivity of total FDI flows to tax and similar incentives is very low....
>
> 'Operating in a more flexible bargaining context should make it generally possible for developing countries to desist from offering excessive tax concessions because they can build their appeal more directly around those specific elements of their genuine location advantages that compliment the needs of particular transnational corporations.'[22]

For developing countries, it is now widely argued, assurances on security of investment, and on access to foreign exchange, are more efficient ways of attracting foreign investment.[23]

It is also beneficial to reduce of administrative and regulatory barriers to foreign investment, but this should not be done to the detriment of the conditions of work, and of the environment.

- Therefore, during the transitional period, South Africa must assure foreign investors on the issues of: security of investment; access to foreign exchange; and the minimisation of bureaucratic obstacles to foreign investment.

If fiscal incentives are to be offered, it would make more sense to do it on a case-by-case basis, or through a system of incentives that does not discriminate against domestic firms. The most obvious example here is the realm of export incentives. It is precisely export-oriented foreign investors, rather than those oriented towards the local market that are most sensitive to the availability of incentives.

Why should a foreign-owned exporter receive benefits not available to locally-owned firms?

- The broad range of incentives developed in terms of a coherent industrial restructuring programme should be made available to foreign and local investors.

- Foreign firms in sectors defined as particularly important for South Africa's development strategy should be offered special incentives packages which could include exchange control privileges, which would be especially relevant in the transitional period.

- Trade policy must be designed to obtain the best possible access to foreign markets in order to attract export-oriented foreign (and domestic) investors.

It is not incentives in themselves that are problematic, but incentives that are simply designed to increase the **quantity** of foreign investment, without being located within a broader industrial strategy.

For firms that are interested in the home (and regional) market, and it would seem fair to suggest that this would apply to the majority of potential foreign investors in South Africa in the short- to medium-term, the most important factors are the size and rate of growth of the domestic and regional markets ('host country market size is an almost immutable determinant of the level of FDI'[24]), and political and economic stability and predictability.

- Government policy should concern itself primarily with economic growth and political stability which will underwrite the domestic market, rather than sacrifice (tax) revenues that could be used to these ends through expenditures on the social and economic infrastructure.

A linked issue of importance to South Africa is how the countries of the Southern African region will address the issue of foreign investment policy. Clearly, the removal of trade barriers between South Africa and its neighbours (broadly defined), could help attract foreign investors to South Africa. However, it is equally likely that South Africa's partners in such a trade preference area or common market would attempt to attract foreign investors to take advantage of access to the South African market.

- For this reason, it will be necessary to consider the harmonisation of policies towards foreign investment as an integral part of the process of regional integration.

Without it, the countries of the region will inevitably compete against each other by offering increasingly generous incentives to foreign investors, which will be to the detriment of the region as a whole. For this reason, South Africans should be talking to our neighbours from the earliest possible time about foreign investment policies.

6 The politics of foreign investment

In many countries some people fear domination by foreign investors. This is a particularly sensitive issue when a country is economically weak, and indeed open to foreign domination, but it is even an issue in the United States today, because it received unusually large amounts of foreign investment in the 1980s. This is not an issue to be dismissed, and it is certainly a concern of many in South Africa today, even though there is no real prospect of foreign domination.[25]

The politics of foreign investment cannot be wished away. In the immediate future, we have to be very sensitive to the prospect of foreign firms taking up business opportunities at precisely the time that black business people hoped, for the first time, to get a real stake in the South African economy. This perceived clash of interests, more than any other issue, has the potential to further politicise the question of foreign investment.

Even if one ignores questions of morality and equity, the success of black business is a vital ingredient for the long term success of the economy. One way of strengthening black business and depoliticising the issue of foreign investment would be for foreign investment policy to incorporate a powerful strategy to boost the position of black business.

- In the field of direct investment, boosting black business could involve joint ventures and partnerships of various kinds. In the field of portfolio and other indirect forms of investment, as well as through non-equity links such as franchises and licensing arrangements, policy could direct significant resources towards black business.

One reservation about this approach is that it could have the effect of linking the economic fate of the black elite too strongly to the interests of foreign capital. The best solution would be ensure that there are also strong elements of black business that are not closely linked to foreign partners.

May, 1993

Footnotes

1. Relatively capital intensive foreign enterprises might replace more labour intensive operations leading to a net job loss, and by diverting part of the proceeds of the enterprise abroad, act as a drain on the domestic economy.

2. E. Osborne, 'Growth over the last three decades', Nedbank Guide to the Economy, November, 1991.

3. International Monetary Fund, Economic Policies for a New South Africa, Washington DC, 1992, p. 14.

4.'... the central problem remains the translation of savings into investment rather than low savings, *per se*.' N Seidman Magetla, 'Savings, growth and redistribution: A statistical approach' MERG Workshop paper, April 1993.

5. United Nations Centre on Transnational Corporations, Transnational Corporations in World Development: Trends and Prospects, United Nations, New York, 1988, p. 139.

6. Brian Kahn argued strongly in 'Import Penetration and Import Demand in the South African Economy', South African Journal of Economics 55:3, 1987 that South Africa remained heavily dependent on the importation of sophisticated capital and intermediate goods. Using South Africa's trade performance in the 1980s, Kevin Lings argued ('The myth of manufactured imports', Nedbank Guide to the Economy, May 1992) that this dependence has lessened. An examination of the IDC 'Sectoral Data Series: Manufacturing', January 1992, in the series of tables on 'Imports as a percentage of total domestic demand', suggests that Lings erred by concentrating on the volume of imports in a period when fixed investment was very low, rather than looking at import propensities.

7. United Nations Centre on Transnational Corporations, The Determinants of Foreign Direct Investment: A Survey of the Evidence, United Nations, New York, 1992, p. 53.

8. W.W. Schneidman, 'OECD Perceptions of Direct Investment Opportunities in a Post _Apartheid South Africa', paper for the IDASA Forum on Investment in a Post-Apartheid South Africa, 1992, p. 9.

9. S. Lall, 'Technological Capabilities and Industrialisation', World Development, 20:2, 1992, p. 179.

10. UNCTC, 1988, op. cit., pp. 175-194.

11. A Hirsch, The External Environment and the South African Trade Policy Debate, Economic Trends Working Paper No. 12, Development Policy Research Unit, University of Cape Town, 1992.

12. Including parent companies in the US, foreign affiliates of US TNCs, and US affiliates of foreign corporations. United Nations Centre on Transnational Corporations, World Investment Report 1991: The Triad in foreign direct investment, United Nations, New York, 1991, p. 69.

13. Ibid.

14. The term 'developing countries' in this paper refers to the middle element of the economic hierarchy of nations consisting of: developed countries (amongst which South Africa is erroneously often included), i.e. largely the O.E.C.D.; developing countries; and least developed countries. These roughly parallel the World Bank's high, middle, and low income countries.

15. The ten largest recipients of FDI inflows in the late 1980s were Argentina, Brazil, China, Egypt, Hong Kong, Mexico, Malaysia, Singapore, Taiwan, and Thailand. Source: Trends on foreign direct investment, Report of the Secretary General, United Nations, New York, 1992, Table 6.

16. United Nations, 1992, op. cit.

17. UNCTC, 1991, Table 2.

18. W.W. Schneidman, 1992, op. cit., p. 7.

19. Ibid, p. 16.

20. M Gittelman and J Dunning. 'Japanese Multinationals in Europe and the United States in Michael W. Klein and Paul J.J. Welfens, eds, Multinational Enterprises in the New Europe and Global Trade, Springer, New York, 1991. See also Young-Kwan Yoon, 'The Political Economy of Transition; Japanese Foreign Direct Investments in the 1980s', World Politics, 43:3, October 1990.

21. David Gold, 'The determinants of FDI and their implications for host developing countries', The CTC Reporter, No.31, Spring 1991; and United Nations Centre on Transnational Corporations, Government Policies and Foreign Direct Investment, United Nations, New York, 1991. See also, Friedrich Schneider & Bruno S. Frey, 'Economic and Political determinants of foreign direct investment', World Development, 13:2, 1985; Louis T. Wells, 'Investment incentives: an unnecessary debate', The CTC Reporter, No. 22, Autumn 1986, and the articles by Stephen E. Guisinger, and Trevor Farrel in The CTC Reporter, No. 20, Autumn 1985.

22. UNCTC, 1992, op. cit. p. 60.

23. Ibid, p. 61.

24. Ibid, p. 59.

25. For a recent review of attitudes towards transnational corporations see Charles R. Kennedy, Jr., 'Relations between transnational corporations and governments of host countries: a look to the future', Transnational Corporations, 1:1, 1992.