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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

# Investment Climate Reform in South Africa

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**Key Messages**

1. Foreign and domestic investment levels in SA remain below the average for other developing and emerging markets despite improved macroeconomic conditions and success in some sectors, e.g. the motor industry
2. SA demonstrates the importance both of crafting a unique investment identity and the role of domestic investment to demonstrate confidence.
3. Business confidence and market sentiment are highly sensitive to opaque regulations and regulatory uncertainty.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

## INTRODUCTION

1. South Africa's (SA) regulatory regime and enabling environment for investment have undergone progressive transformation and liberalization since the early 1990s with a view to stimulating higher levels of public and private sector economic activity. A central challenge facing the SA government that took office in April 1994 was to build a modern and vibrant economy that is outward oriented and internationally competitive, while simultaneously addressing the massive backlogs in access to social and economic services. Some key messages emerging from the SA experience are:

(i) Investment climate reform has led to increased levels of long-term investment by domestic and foreign firms, although the rate of new investment has not met expectations. Foreign capital inflows have not been on par with other competing developing countries or emerging markets with broadly similar risk profiles. Investment as a percentage of GDP has averaged around 16-17%, which is low by the standards of successful developing countries, even those in Africa.

(ii) SA has sequenced its reform process from first addressing macroeconomic issues and then shifting its attention to the microeconomics of investment in general and the efficient functioning of factor markets.

(iii) Although SA is fairly competitive with regard to a raft of generic host country factors, this has not been sufficient to attract investment. SA demonstrates the importance of crafting a unique investment identity for a country by actively marketing its commercial potential, identifying targeted opportunities, and facilitating the investment (hence the roles of the International Marketing Council and the International Investment Council).

(iv) Business confidence and market sentiment are highly sensitive to opaque regulations and regulatory uncertainty. This is clearly illustrated by the implementation of Black Economic Empowerment (BEE) in SA, which has not been adequately and effectively communicated to investors (e.g. the leak of the draft Mining Charter in 2002).

(v) For SA to win the confidence of foreign investors as a viable market to invest in, domestic firms need to lead the way and show trust in the economy. This will involve addressing the underlying confidence issues in the economy.

(vi) The real challenge in SA is to ensure an overall socio-economic environment that is conducive to a pipeline of bankable projects, rather than FDI-targeted interventions.

*The following factors and trends explain why, despite SA's relative economic strength and lack of barriers to business, investment rates remain low:*

Domestic market structure and potential:

2. SA's domestic market is relatively small and segmented, and not growing fast enough to induce mass production type investment projects. Key to SA's industrial performance is the ability to attract export-oriented FDI, which will reinforce the current momentum of export-orientation (e.g. SA's success in attracting automobile OEMs to utilize the country's potential as a competitive exporting location).

3. SA is highly concentrated in virtually all industries, with anti-competitive practices over several decades responsible for amongst the highest four-firm concentration ratios in the world. This includes both horizontal oligopolization as well as vertical integration which leads, through tied contracts, to a lock-out of any foreign investor in the main inward-oriented production, warehousing, distribution, marketing and retailing networks.

4. SA's capital markets are relatively well-developed and can finance the current level of viable, bankable projects. In the past, due to the depreciating nature of the Rand, local capital has been a more cost-effective substitute for FDI.

5. The impact of SA's geographic distance from world markets on attracting investment depends on the type of FDI and the nature of the industry, i.e. positive (e.g.

counter-seasonal production, business process outsourcing, high value to weight ratio products, location-specific benefits, etc) or negative (e.g. low value to weight ratio products, tight lead times to world markets, business spillovers, etc).

Poor Market intelligence:

6. FDI investors are making long-term calculations, and their poor understanding of democratic SA has been a significant constraint. AT Kearney (2000) suggests that SA's main challenge is to define and project its identity as an investment destination distinct from the rest of Africa. Potential investors often view SA as another African commodity exporting country, rather than a country that is diversifying and strengthening its capacity in high-value manufactures and a greater services component in GDP.

The role of domestic investment:

7. Private fixed investment has tended to move in the same pattern with public fixed investment. Foreign investors are said to be delaying investing in SA due to domestic corporate excess savings which are not being productively re-invested. In turn, the private sector is awaiting its trigger from efficiency improvements in government investment spending, particularly on infrastructure (constrained in the past by the tight fiscal policy and SOE restructuring).

Regulatory and institutional conditions:

8. This involves confidence and consistency in public policy reforms affecting business,[1] BEE requirements, and hidden transactional costs (i.e. logistical, transport and bureaucratic costs). Gelb (2002) finds that some investors perceive that there has been deterioration in SA's institutional-regulatory environment. AT Kearney (2000), however, suggests that SA's attractive regulatory and business environment is the main investment driver in SA. The World Bank's World Business Environment Survey

(WBES) also finds that the registration process for new businesses in SA is more efficient than in several other developed countries, although SA is less efficient with respect to contract enforcement.

Social risks:

9. The relatively high levels of crime in SA compared to other competing developing countries raises business costs (i.e. higher insurance costs, disruption in production activities, etc).

10. HIV/AIDS does not feature prominently in investor surveys on SA. The high incidence of HIV/AIDS in SA could contribute to a slowdown in multi-factor productivity growth and add to the erosion of SA's social capital. This is an important risk factor, which necessarily impacts on risk-adjusted rates of return on investment.

Cost of capital:

11. The cost of capital relative to SA's main trading partners (in particular the prime interest rate and the cost of equity premium), coupled with exchange rate volatility of the SA Rand, are said to be barriers to investment. For SMMEs, access to capital is a particularly major constraint.

12. Gelb (2002) finds that investors have limited the number of greenfield investments they make in SA as a way of mitigating the adverse effects of exchange rate fluctuations, which can result in asset devaluations in home currency terms. Other potential strategies which investors employ to mitigate this risk include favouring partial acquisitions and investing in services so that their investment is not in physical capital and is more easily reversible.

Labour market issues:

13. SA's labour market is regularly cited as over-regulated and inflexible, and a significant constraint on investment. The SA National Enterprise Survey (2001) found that labour-related issues (regulations and costs) were the most important reasons for reducing employment levels, especially for small firms. However, the survey suggests that the *perceptions* about labour regulations are the problem rather than their actual impact on firm employment and profitability. The World Bank's WBES also finds that SA has the eighth least regulated labour market out of more than 130 countries.

14. An inadequately skilled labour force and a severe mismatch between the nature of the demand for labour and the quality of labour supplied are significant obstacles to increased investment (particularly in ICT, engineering, financial services and heavy manufacturing).

## Investment Climate Reform in South Africa

| Economic Policy Instruments | Components |
|---|---|
| **1. Macro-economic policy:**<br><br>• **Reconstruction and Development Programme (RDP)**<br>• **Growth, Employment and Redistribution Strategy (GEAR)**<br>• **Micro-economic Reform Programme**<br>• **Integrated Manufacturing Strategy** | • Economic environment<br>• Fiscal policy<br>• Monetary policy<br>• Restructuring / Privatization<br>• Deregulation, improved regulatory quality<br>• Trade and industrial policy<br>• Competition policy<br>• Labour market<br>• Best practice corporate governance<br>• Security of property and contractual rights<br>• Black Economic Empowerment (BEE) |
| **2. Incentives, industrial support and supply-side measures** | • Financial and fiscal<br>• Spatial interventions (SDIs, IDZs)<br>• Public-Private Partnerships (PPPs)<br>• Infrastructure<br>• Skills, training and education<br>• Other |
| **3. Voluntary and Obligatory Performance Requirements (PRs)** | • Export PRs<br>• Technology transfer PRs<br>• Research and development PRs<br>• Employment and training PRs<br>• Joint venture or domestic equity PRs |
| **4. Bilateral and multilateral legal instruments** | • Bilateral Investment Treaties<br>• Avoidance of Double Taxation Treaties<br>• WTO: TRIPS, TRIMS, GATS |
| **5. Investment facilitation and promotion** | • Trade and Investment SA (DTI TISA)<br>• Provincial investment promotion agencies<br>• International Marketing Council<br>• Presidential Working Groups: *Trade Unions, Big Business, Black Business, Commercial Agriculture.*<br>▪ Presidential International Advisory Structures: *International Investment Council, International Task Force on Information Society and Development.* |
| **7. Socio-political context, governance and institutions** | |

Growth, Employment and Redistribution strategy:

15. Economic environment: The national macroeconomic strategy GEAR, launched in 1996, was oriented towards a competitive global economy, with strong emphasis on fiscal discipline, investor confidence, economic stability and a restructured public sector that would raise the efficiency of both capital expenditure and service delivery. The GEAR rested on two motors for economic growth: an expansion of non-traditional (non-gold, manufactured) exports, and an increase in private sector investment.[2]. GEAR also emphasized higher levels of public investment, particularly in infrastructure, in the expectation that this would crowd -in private investment and improve short-term economic performance. The GEAR emphasized economic growth as a powerful stimulus of FDI and stated that increasing FDI requires paying attention to the fundamental determinants of international investment decisions and the underlying macro-economic expectations which may be relevant. These might include: political and economic stability, including macro-economic stability and clarity about economic policy, sustained high rates of economic growth, labour market stability, investment incentives, the tariff regime, protection of property rights, and various determinants of expected investment returns (SA Government, 1996).

16. One of the key objectives of GEAR, economic stability, has largely been achieved. Since 2001, the government has shifted its economic policy focus to removing the remaining micro-economic obstacles to investment and bolstering SA's international competitiveness. BEE is also critical for the long-term success of the economy. BEE seeks to broaden the economic community of entrepreneurs (particularly SMMEs) amongst the historically disadvantaged people of SA. Gelb (2002), however, finds that FDI, at least by firms newly entering SA, has not been a major vehicle for expanding BEE ownership levels during the 1990s. Empowerment has been realized more in relation to participation in the directing of economic assets than in relation to ownership. Public procurement has also not proved an effective lever to promote BEE equity stakes in foreign investor affiliates. BusinessMap (2003)

moreover notes a rising trend in disinvestment from SA, although small in absolute terms, which is often related to BEE and the need to roll-back white control of the economy through the implementation of equity targets.

Monetary policy:

17. The adoption of an inflation targeting framework (a band of 3-6%) that has improved the transparency of the South African Reserve Bank's (SARB) policy framework.

18. Preserving the independence of the SARB, thereby safeguarding monetary policy against political pressures.

19. A significant reduction to zero of SA's oversold forward book, which has been viewed with negative sentiment by most market participants, international rating agencies, and the investment banking community.

20. A gradual liberalization of the capital account and exchange controls, including a significant increase in the private individual allowance for outward investment in other African countries. In view of its many inherent disadvantages, all remaining exchange controls will be dismantled as soon as circumstances are favourable.

21. The relaxation of access to domestic credit for foreign investors (foreign-controlled firms are subject to domestic borrowing restrictions).

Fiscal policy:

22. Adopting the principle of national treatment for foreign investors.

23. A broadening of SA's tax base, including the introduction of Capital Gains Tax (CGT) and taxation of foreign income earned by South African individuals abroad, among others.

24. A reduction of the standard corporate tax rate and the secondary tax on companies, which have reduced the combined tax rate (for non-mining companies) from 48% to 39% since 1996. There are, however, concerns about creeping forms of taxation (e.g. the skills levy on wages, the obligations of empowerment programs, and municipal rates and levies are seen to be unpredictable additions to the tax burden of firms).

25. A shift from inefficient and harmful tax incentives (i.e. tax holidays) to internationally acceptable investment measures (i.e. accelerated depreciation for qualifying production assets).[3] These tax reforms have created an environment that is internationally competitive, thereby improving SA's investment climate.

26. A restructuring of government expenditure towards social services and investment in infrastructure.

Restructuring, Privatization and Deregulation:

27. The government has embarked on a gradual program of restructuring, privatizing or further commercializing state-owned enterprises (but not necessarily liberalizing markets). This has included the creation of new sector-specific regulators (particularly transport, telecoms and energy sectors).

Microeconomic Strategy:

28. The government implemented a microeconomic reform strategy in 2002, to complement progress made on the macroeconomic frontier.

29. This strategy is focused on removing factors that limit accelerated growth and development within the microeconomy and as such it focuses on key cross-cutting areas, including technology, human resource development, access to finance for SMMEs and BEE businesses, and infrastructure development. Key input sectors such as transport, telecommunications, and energy have also been targeted to improve microeconomic competitiveness.

30. Key microeconomic reforms to date include: negotiation of a new labour relations dispensation, development of new legislation and an institutional framework for skills development (including creating Sector Training Authorities to develop and promote sector-specific skills), and the development of a new small business development institutional framework and supporting legislation.

Trade and Industrial Policy:

31. After the lifting of sanctions, SA actively participated in trade negotiations on both a bilateral and multilateral level. The government has targeted a number of strategic partner countries with which to develop economic relations through bilateral Free Trade Agreements, including the EU and SADC countries.

32. A comprehensive reform (and reduction) of protection for domestic industries, including a commitment to reduce the number of tariff categories from over one hundred to six, a significant reduction of South Africa's average tariff, thereby reducing the anti-export bias.

33. A revamp of industrial support measures, moving away from market distorting demand-side measures (i.e. export subsidies provided under the General Export Incentive Scheme) to efficiency enhancing supply-side measures. The latter is geared to support higher value-added manufacturing projects, increased competitiveness and improved productivity. SA's key investment incentive offerings include:

- *Industrial Development Zones (IDZs)*: a world-class, purpose-built industrial estate that contains a controlled Customs Secured Area[4] and is linked to an international airport or port.
- *Strategic Industrial Projects (SIP).*
- *Critical Infrastructure Programme*.
- *Foreign Investment Grant (FIG).*
- *SMME Development.*

34. The government's sectorally-directed programs and targeting of key growth industries have largely been successful (e.g. the export-oriented motor industry, incentivized by the *Motor Industry Development Program*).

35. Under its WTO commitments, SA does not impose any onerous performance requirements (PRs) on investors. Voluntary PRs are linked to the receipt of an advantage, such as an industrial support measure. Obligatory PRs are legislated for employment and training, and equity requirements are set for government procurement and licenses in deregulated industries.

36. A major overhaul of competition policy to deliver on restricting anti-competitive practice, eliminate the abuse of dominant positions, and strengthen merger control as well as to improve competitiveness and roll-back white minority control of the economy; (vi) An introduction of a new industrial policy, the *Integrated Manufacturing Strategy*, which focuses on the integration of interventions to enhance SA's competitiveness. These interventions are targeted at areas such as: market access, beneficiation and value-addition, regional production, equity and economic participation, knowledge intensity and services integration, and the development of integrated value matrices.

## EVALUATION OF SOUTH AFRICAN INVESTMENT CLIMATE REFORM

37. Over the past decade, the government has progressively crafted and put in place a highly permissive and liberalized investment climate, although levels of long-term investment, both from abroad and from domestic sources, have remained below expectations. Although SA's ratio of FDI as a percentage of Gross Fixed Capital Formation has increased significantly since 1990, it is still below the averages for both developed and developing countries.

## Figure 1: FDI Inflows % of Gross Fixed Capital Formation (GFCF)

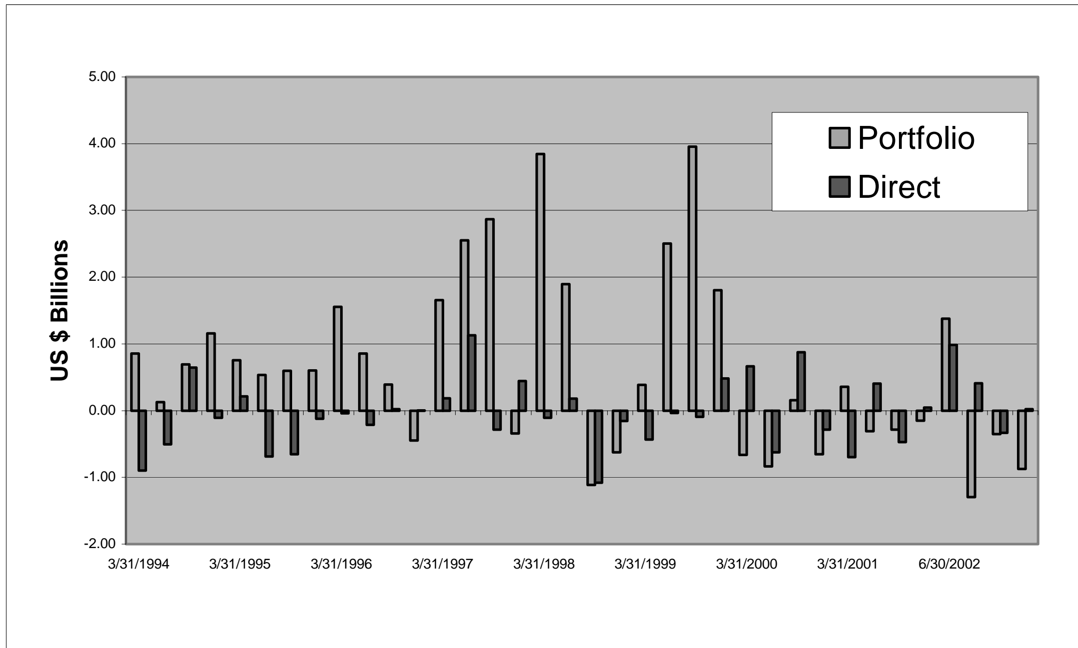
*Note: * Excludes data for 2001, since FDI for that year was unusually high due to the buy-out of De Beers minority shareholders by Anglo American.*

| | Average 1990-1995 | Average 1996-2002 | Average 1996-2002* | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| World | 4.14 | 12.37 | 12.37 | 5.96 | 7.51 | 10.87 | 16.5 | 20.83 | 12.77 | 12.17 |
| Developed Countries | 3.67 | 12.32 | 12.32 | 4.83 | 6.02 | 10.4 | 17.07 | 22.9 | 12.72 | 12.27 |
| Developing Countries | 5.58 | 12.10 | 12.10 | 9.12 | 11.38 | 12.01 | 14.35 | 14.61 | 12.72 | 10.52 |
| | | | | | | | | | | |
| Ireland | 12.72 | 59.34 | 59.34 | 19.22 | 16.8 | 45.39 | 81.44 | 115.9 | 65.71 | 70.91 |
| Czech Republic | 4.91 | 29.75 | 29.75 | 7.78 | 7.93 | 22.31 | 41.29 | 34.26 | 35.55 | 59.14 |
| Chile | 13.57 | 27.51 | 27.51 | 24.09 | 23.48 | 22.31 | 56.91 | 22.92 | 31.44 | 11.44 |
| Singapore | 32.16 | 25.93 | 25.93 | 26.58 | 36.98 | 24.71 | 47.58 | 45.63 | 43.76 | .. |
| Brazil | 1.98 | 19.50 | 19.50 | 7.23 | 11.84 | 18.61 | 28.17 | 28.4 | 22.69 | 19.57 |
| Argentina | 9.17 | 18.76 | 18.76 | 14.12 | 16.14 | 12.23 | 46.94 | 25.32 | 8.41 | 8.18 |
| Mexico | 10.02 | 15.12 | 15.12 | 16.75 | 18.1 | 13.83 | 12.62 | 12.56 | 20.67 | 11.33 |
| Hungary | 23.70 | 13.57 | 13.57 | 23.53 | 21.32 | 18.32 | 17.2 | 14.61 | 20.06 | .. |
| Malaysia | 19.45 | 12.05 | 12.05 | 17.03 | 14.65 | 13.96 | 22.21 | 16.52 | 2.53 | .. |
| **South Africa** | **1.32** | **11.27** | **6.40** | **3.5** | **15.54** | **2.48** | **7.44** | **4.67** | **40.47** | **4.78** |
| China | 9.85 | 9.10 | 9.10 | 14.32 | 14.58 | 13.11 | 11.32 | 10.35 | 10.53 | .. |
| India | 0.92 | 2.04 | 2.04 | 2.87 | 3.98 | 2.9 | 2.24 | 2.28 | 3.23 | .. |
| Indonesia | 4.81 | -1.23 | -1.23 | 9.2 | 7.66 | -1.47 | -9.74 | -14.26 | -10.82 | .. |
| | | | | | | | | | | |
| Developing countries excl. China | 4.76 | 8.82 | 8.82 | 7.99 | 10.65 | 11.7 | 15.33 | 16.05 | 13.61 | .. |

Source: World Investment Report 2003

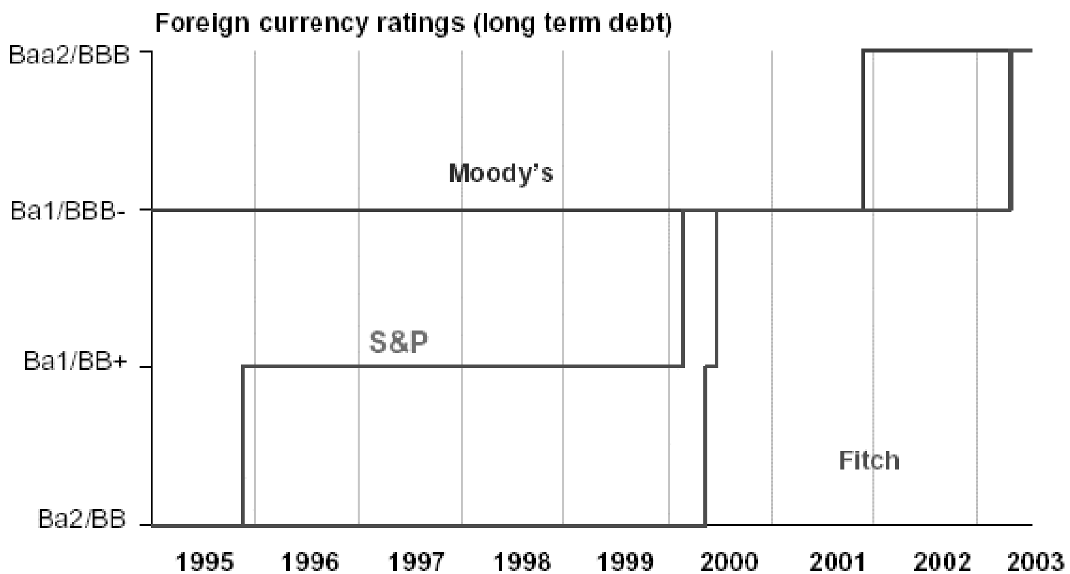
38. As can be seen from Figure 2, although SA has recorded net positive FDI inflows, most of these have been short-term portfolio flows destined for the bond and equity markets. Continued upgrades in SA's currency ratings by international investment rating agencies (see Figure 3), coupled with high interest rates (relative to its main trading partners in the North) have improved SA's credentials for FDI. The bulk of these inflows have been absorbed by the private sector. Although there has been an accompanying surge in private sector access to credit, Mohamed (2003) finds that the private sector has not utilized its improved access to credit for productive investment. Easier access to credit has instead supported existing negative trends in the economy, including growing household consumption and imports, higher share prices, and capital flight. He argues that the surge in inflows is cause for concern because of the potential for instability it produces in the economy.

## Figure 2: Net Capital Inflows: FPI vs FDI (US$ Billions)




*Source: Deutsche Bank/I-Net Bridge. Note: the Anglo-American/De Beers deal is excluded, as it was an exceptionally large-scale transaction*

## Figure 3: SA's foreign currency ratings, 1995-2003



39. There has been little greenfield FDI into SA, and where this has occurred, it has largely been of a mega-project nature. Inward FDI into SA has increasingly taken the form of M&As, largely as a result of state-leveraged deals and public sector restructuring. These transactions point to the highly developed nature of SA's equity markets, enabling asset purchases of this nature. Gelb (2002) finds that a relatively high proportion of investors interested in SA see the country's asset base as broadly similar to what they are familiar with. Since the beginning of 2000, there has been an improvement in net FDI, including greenfield investments by foreign investors. This can be expected to continue to improve if domestic conditions and policies continue to provide the fertile ground for investment. The increased rate of fixed investment by government over the same period will contribute directly, and through encouraging further private investment (The Presidency, 2003).

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## Notes

[1] Since 1994, there have been over 500 legislative changes affecting business in SA. While much of these were necessary measures, they have also introduced an enormous amount of new complexity – and thus effectively new costs – into the business environment (CDE, 2001:20).

[2] According to GEAR, for growth to take place, gross domestic investment had to increase from 20% to 26% of GDP, which required capital inflows equivalent to 4% of GDP, or more than five times the 1994 level. Policy-makers therefore viewed an increase in direct investment, relative to portfolio investment, as crucial to maintain low interest rates (DI is generally less volatile than PI) and therefore to encourage domestic investment

[3] The Tax Holiday Scheme, introduced in 1996, was phased out in September 1999 and replaced with an overall reduction in corporate tax rates from 35% to 30% of profits.

[4] A Customs Secured Area is exempt from customs duties on imported goods to be used in production and manufacturing of goods in the IDZ as well as on capital equipment, and VAT on supplies procured in SA is suspended. All existing SA legislation and regulations (labour, environment, etc) apply in the IDZs, thereby breaking with the practice of many other countries that have used IDZs and Export Processing Zones (EPZs) as mechanisms for reducing the obligations of foreign investors. To date, no competition signals have been identified from or through the two EPZs that exist in the SADC region, in Namibia and Mauritius.