FOREIGN DIRECT INVESTMENT IN SOUTHERN AFRICA: DETERMINANTS, CHARACTERISTICS AND IMPLICATIONS FOR ECONOMIC GROWTH AND POVERTY ALLEVIATION

Carolyn Jenkins and Lynne Thomas

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CSAE
University of Oxford
Manor Road Bldg, Manor Rd, Oxford OX1 3UL

carolyn.jenkins@economics.ox.ac.uk

CREFSA
London School of Economics
Houghton St., London WC2A 2AE

l.thomas@lse.ac.uk

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EXECUTIVE SUMMARY

Introduction

This paper presents the findings of a study analysing the major factors determining the form and volume of private foreign direct investment in Southern Africa. This study aims to ascertain (i) what are the primary motivations for investment in Southern Africa and (ii) whether the form of new foreign investment influences its developmental effects. By assessing the motivations for direct investment in the region and the extent to which FDI contributes to new employment and to skills transfer, it seeks to shed light on appropriate policies to pursue in order to encourage higher volumes of FDI and their likely implications for economic development. FDI is one element linking Southern Africa to the global economy. The volume and forms that can be attracted will influence whether Southern Africa's poor can benefit from globalisation of markets.

Lessons from theory and experience

Determinants of private (domestic and foreign) investment

The economic literature on private capital formation in developing countries is largely concerned with the issue of uncertainty and risk as disincentives to investment. Macroeconomic instability is found to be a disincentive as is the presence of large external debt burdens. The variability of both the exchange rate and the rate of inflation - more than their levels - causes investors to hesitate to commit significant resources. Uncertainty about the future will dominate decision-making, even when potentially profitable opportunities exist. For this reason, lags in the investment response to macroeconomic adjustment can be very long. Political uncertainty exacerbates perceptions of a fragile investment climate.

Determinants of foreign direct investment

Multinational enterprises may base FDI decisions on one or more of the following factors: a secure and cheaper source of regularly required inputs; the desire to defend or expand markets or service existing clients in a particular foreign region; the wish to rationalise production into a network of the most efficient production bases supplying the largest possible worldwide market; and other strategic considerations with respect to the firm's international position. These can be summarised as providing two distinct motives for FDI: market access and production costs. The former derives from the gain of being close to consumers, and tends to be associated with distribution outlets and/or production purely for the local market. The second arises from the benefits of being able to base production in low-cost locations, and tends to be correlated with export orientation.

Foreign direct investment in Africa

Although these determinants apply generally to multinational investment, there are features particularly important to Africa which should be taken into account. The indicators which have been found most frequently to be correlated with increased FDI in Africa in cross-country empirical analyses are: economic openness, especially to international trade; the quality of institutions and physical infrastructure in the host economy; and economic growth and stability. Investor surveys in Africa have tended to emphasise economic instability and institutional weaknesses as the main barriers to increased levels of FDI.

The developmental effects of FDI

The developmental benefits of FDI are not automatic, and mechanisms may be required to ensure that the expected benefits of FDI are equitably distributed in order to make a positive impact on poverty alleviation and social welfare. Possible developmental benefits include employment creation, the promotion of forward and backward linkages in the host economy, the development of human capital, the implementation of internationally acceptable codes of employment practice, improving the access of the host economy to world markets, and augmenting corporate tax revenues.

FDI in Southern Africa: an overview

The experience of SADC members in attracting long-term capital flows has been mixed. In US dollar terms, the amount of FDI received by SADC is a small fraction of total flows to low and middle income economies: between 1995 and 1999, the approximate share of SADC in total FDI to developing countries varied between 2 and 3 percent. However, for some countries in the region, annual inflows expressed as a percentage of GDP have, at times, significantly exceeded flows to other developing economies: for instance Angola in 1998-9; Lesotho and Seychelles in 1995-99; and Mozambique in 1999. This is often explained by a limited number of large transactions in relatively small economies, including investment in natural resource exploitation and infrastructure development, and also privatisation transactions. Privatisation has been an important source of FDI for some SADC countries - such as Mozambique, Tanzania and Zambia - but, in general, slow progress in the sales of the largest parastatal entities suggests that there is considerable scope for further inflows of foreign investment over time.

South Africa dominates foreign investment in SADC, receiving a substantial fraction of new FDI inflows into the region and hosting the greatest number of foreign subsidiaries across a broad range of economic sectors. South Africa's capacity to act as a magnet for FDI in the region, particularly in the context of growing regional economic integration, is an important feature of investment flows.

Determinants and characteristics of FDI in Southern Africa

The analysis in this study draws on a survey conducted with (predominately) European parent companies with operations in SADC. This survey aimed to explore the following issues: motivations for investment; the market orientation of subsidiaries in Southern Africa; decisions on expansion versus contraction and implications for employment; the ownership structure of investments; the method of entry into the host economy; the impact of economic policy on operations in SADC; and perceptions of risks.

Motivations for investment

The most important motivation for investment in Southern Africa is the size of the local market. Most of the non-primary sector enterprises in the sample have a local market focus, and few are seeking to develop export capacity to markets outside the region in the medium term (the exceptions are all located in South Africa). The creation of a functioning free trade area is likely to provide the economies of scale needed for profitable production, and thus should encourage more direct investment in the region. South Africa - the largest domestic market in Southern Africa - is seen by many investors to be pivotal for regional production and trade.

Other important motivations for investment include the presence of natural resources; historical links with Africa; privatisation programmes or public-private partnership schemes; and - for several service sector firms - strategic factors associated with servicing global corporate clients. Firms with long-standing historical links are more likely to remain in times of uncertainty, even when new firms might be deterred from entry, and may be significant sources of additional investment over time.

As a motivation for location in Southern Africa, market seeking is more important than cost considerations. South Africa is more attractive than its neighbours for secondary- and tertiary-sector enterprises, and it acts as a base for production for the region and, in some cases, for exporting to the rest of the world. The main location-specific reasons for this pattern is superior infrastructure, physical and financial, and the fact that South Africa is by far the largest economy.

Enterprise growth and employment

Half of the firms interviewed in this survey increased the scale of (existing) operations in the past five years, and just over half are planning expansion in the next five. However, enterprise growth is not always accompanied by employment growth. In manufacturing, rising capital intensity and improved productivity may limit the benefits of FDI in terms of ongoing job creation. On the other hand, skills transfer and joint ownership of assets with local partners is taking place in the region, although most firms in the sample tend to prefer to retain management control.

Mode of entry

There is some indication of an increase in the proportion of acquisitions in the last five years, in line with world trends, but the shift is too small to indicate a significant change, and this may be a temporary phenomenon as foreign firms take advantage of privatisation programmes, which necessarily draw in foreign capital via acquisition. Greenfield investment continues to play an important role. Acquisitions tended to occur in the primary sector; while greenfield investments were more likely in the service sector.

Ownership structure

The choice of ownership structure tends to reflect the internal preferences of parent companies with respect to control of their foreign subsidiaries. This is more influential than any factors specific to the host economy or investment project. There is some weak evidence that full foreign ownership occurs more frequently among secondary- and tertiary-sector firms producing for export markets, indicating that control is viewed as important for quality and consistency of supply.

Sources of risk

Foreign exchange and the quality of governance are the most common risk factors identified by this sample of investors. Foreign exchange risks include instability of exchange rates, particularly for those firms producing for local and regional markets, and availability of foreign exchange for importing inputs and repatriating profits. Concerns about quality of governance cover a range of issues, including the risk of intervention in property rights, corruption, and bureaucratic uncertainty.

Other indicators of economic and political stability do not appear to have any consistent influence on the characteristics of foreign investments in the sample. One reason for this is that economic reform in several countries in the region may still be too fragile and too recent for it to have had a marked effect on private investment behaviour.

Investors frequently argued that the "Africa perception" is a barrier to attracting new firms into the region. Unfavourable perceptions of the credibility of reforms may well have their greatest impact on those multinational corporations which are not yet committed to investment in Africa. In other words, the view that instability is endemic across Africa, serves to undermine efforts to attract potential FDI to the region.

Policy implications

Market orientation: local markets and regional integration

The primary reason for locating in Southern Africa is to take advantage of the local market. Most of the non-primary sector enterprises have a local market focus, and - with the important exception of several firms located in South Africa - these enterprises are not seeking to develop global export capacity in the medium term.

Market size is influenced by the number of people to whom goods can be distributed and the volume of their disposable income. Where domestic markets remain small, only a limited number of foreign investors are likely to enter. *Economic growth* to increase the size of the local market may therefore need to be a precursor to higher levels of FDI.

In the meantime, a functioning and sustainable *free trade area* is more likely to offer the economies of scale required for investment to be profitable, and thus should encourage more direct investment in the region. There is a risk that much of the FDI flowing into SADC will locate in South Africa. Regional initiatives thus need to be designed carefully to ensure the benefits of new FDI are broadly spread across the region. Where core economies attract most foreign direct investment from outside the region, *intra*-regional resource flows may be encouraged by the removal of exchange controls, particularly on FDI. This will enable private capital in larger economies, especially South Africa, to seek profitable investment opportunities in neighbouring countries.

Infrastructural development on a regional basis is a further mechanism for enhancing gains from the FTA for the smaller economies and may also, in the longer term, help to encourage a more even distribution of *extra*-regional FDI. The smaller economies in the region need to develop financial, electronic and physical infrastructure in order both to stimulate domestic investment as well as attract foreign capital.

Market orientation: creating export capacity

Existing markets, particularly local markets, remain the main focus of activities for most of the enterprises in the sample. Where outward orientation of existing enterprises has either taken place or is planned, these are all located in South Africa. For the smaller SADC economies, the domestic market is too limited to generate significant endogenous development. For this reason, it is crucial that production be aimed at a wider market, both regional and global.

Faster capital accumulation is vital, requiring a reduction in the risks to private investment in both physical and human capital. Risks vary across countries but policy measures include conflict resolution, greater political and macroeconomic stability, better legal systems and less corruption. This policy agenda is common to all developing regions irrespective of factor endowments. Where African economies face a particular challenge is in addressing the apparent perceptions of potential international investors that political and economic instability is endemic.

Investment in education, training and research will be crucial in developing new industries, as will investment in transport and communications. Expenditure on infrastructure and education is likely to be of greater importance in the long term than tax and investment incentives for investors.

External factors which are crucial include the reform of the world trading system. It is widely recognised that developing countries require greater negotiating capacity, especially in international fora. Within regional frameworks such as SADC or wider efforts such as NEPAD, cooperation in building a united position on trade negotiations will support a strengthening of such capacity.

Perceptions of risk

The primary disincentives to locating in the region are perceptions of poor governance, volatile exchange rates and/or a lack of access to foreign exchange.

Where volatile exchange rates are symptomatic of macroeconomic instability, the priority must be economic stabilisation. The phasing out or scaling down of exchange controls on non-residents in those countries where they remain, together with ensuring the availability of foreign exchange is essential to attracting investment. Foreign exchange availability is particularly important in terms of acquiring imported inputs and repatriating post-tax profits.

Predictable economic policies and political responses can be considered a prerequisite for FDI. Countries need to be some way along the economic transition route to attract FDI, and lags in the investment response to reforms may be very long, particularly where investors are concerned with the credibility and sustainability of policies. Finally, government regulations and procurement policies may deter some forms of FDI, particularly where they affect ownership. Governments need to weigh the benefits of such micro-level interventions against the costs of erecting perceived impediments to FDI.

Many of the motivations influencing the investment decisions of multinational companies apply equally to domestic investors. Addressing the problems identified by foreign investors already committed to the region should not only in the long run make Southern Africa more attractive to new FDI but should in the shorter term encourage increased domestic investment.

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1. Introduction

The economic policy strategy currently pursued by many Southern African[1] countries is explicitly intended to improve conditions for foreign direct investment (FDI). Over the past two decades many countries have implemented broad ranging economic reforms, including the liberalisation of domestic markets and some privatisation, which has had an effect on the flow and nature of foreign investment. However, Africa has, on average, been relatively unsuccessful in attracting FDI in spite of very large increases in global flows. Even South Africa, which is relatively developed and rich compared to its neighbours, has attracted considerably less FDI than anticipated, in spite of its explicitly investor-friendly macroeconomic policy framework. Moreover, the small and illiquid nature of capital markets in the region (with the important exception of South Africa) has added to the marginalisation of African economies in terms of the allocation of international private capital flows.

It is frequently argued that African economies have not participated in the substantial increase in FDI which has been a feature of globalisation since the 1990s, both because policy environments have historically been hostile to investment generally and because resources which might have gone to Africa have been diverted to the transitional economies of the former Communist bloc. Foreign investors cite a range of reasons for their reluctance to invest in Southern Africa. These include corruption, crime, political insecurity and economic instability. There appears to be general uncertainty about Africa's prospects, rather than any specifically identifiable factors.

The poor investment response - both domestic and foreign - in the region is a particular disappointment to those governments which have reformed economic policy with the intention of creating an investor-friendly environment. The primary objective of these reforms is developmental. It is clear that international capital inflows are a fundamental element in economic performance. Poverty is almost invariably linked to unemployment, rural and urban. Investment is essential for creating new job opportunities in the formal economy, with indirect effects on the informal sector. Where domestic resources to finance investment are limited, foreign capital inflows are necessary.

Earlier research has explained why investment in Africa is low. It has been established, for example, that the macroeconomic policy environment is an important determinant of investment; and that closed trade policy, inadequate transport and telecommunications links, low productivity and corruption make Africa unattractive to potential investors (Bhattacharaya *et al*, 1996; Collier and Gunning, 1999; Collier and Patillo, eds, 1999). However, it is not clear why multinational companies have preferred to take advantage of opportunities in other developing countries, some of which are slow reformers and suffer from corruption and uncompetitive markets. Nor do we know what determines the type of investment taken by multinational companies and whether this

[1] Southern Africa is defined as the membership of the Southern African Development Community (SADC): Angola, Botswana, DR Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

differs according to region. It is also unclear as to whether globalisation has generated a shift towards production in high-productivity countries with fewer jobs being created by FDI in less developed countries.

This paper presents the findings of a study analysing the major factors determining the form and volume of private foreign direct investment in Southern Africa. This study aims to ascertain (i) what are the primary motivations for investment in Southern Africa and (ii) whether the form of new foreign investment influences its developmental effects. By assessing the motivations for direct investment in the region and the extent to which FDI contributes to new employment and to skills transfer, the study seeks to shed light on appropriate policies to pursue in order to encourage higher volumes of FDI and their likely implications for economic development. FDI is one element linking Southern Africa to the global economy. The volume and forms that can be attracted will influence whether Southern Africa's poor can benefit from globalisation of markets.

Our findings are based on a survey of European parent companies investing in SADC, exploring motivations for investment; decisions on expansion versus contraction; and characteristics of foreign enterprises, such as the role of an enterprise (in terms of markets supplied), its ownership structure, and its method of entry into the host economy. Our conclusions are based on the potential impact of investment decisions by parent firms on growth and welfare in the host economy at the macro level.

This paper does not attempt to trace the micro- or household level impact of FDI in Southern Africa. Parent firm survey evidence does not in general permit analysis of trends in household income in the host economy; or whether labour and environmental standards are harmed or improved by the presence of foreign firms. Also, these findings do not differentiate impacts on welfare at a highly disaggregated sectoral level. These are, of course, important research questions in assessing the overall impact of FDI in developing countries.

In the following section, we review the literature on the determinants of FDI and the impacts of FDI on welfare in developing economies. Section 3 discusses trends in foreign investment in the SADC region. The main focus of this paper is an analysis of findings from a survey of 81 foreign-owned enterprises located in SADC. In section 4, a descriptive analysis of survey findings is presented. Section 5 then tests descriptive findings using a microeconometric approach. Section 6 summarises the main findings and presents policy implications.

2. The determinants of FDI and implications for poverty alleviation: review of the literature

There is an extensive literature on the determinants of FDI and on the welfare impacts of private foreign investment in developing countries. For this reason, the following review is broad-ranging and rather long. The main points are summarised in section 2.3, which captures the essence of section 2.1 - which discusses determinants of FDI - and section 2.2 - which discusses the developmental effects of FDI.

2.1 The determinants of foreign direct investment

2.1.1 Determinants of private investment

The theory of the determinants of private investment, irrespective of whether it originates domestically or from abroad, is relevant for an understanding of what drives FDI. This has become increasingly true with the globalisation of world markets, although there remain additional factors which may inhibit or encourage FDI that would not affect domestic investment.

Theoretical studies

Much of the research on the determinants of investment is based on the neoclassical theory of optimal capital accumulation pioneered by Jorgenson (1963, 1971). In this framework, a firm's desired capital stock is determined by factor prices and technology, assuming profit maximisation, perfect competition and neoclassical production functions. This theory was a deliberate alternative to views expressed initially by Keynes (1936) and Kalecki (1937), that fixed capital investment depends on firms' expectations of demand relative to existing capacity and on their ability to generate investment funds (Fazzari and Athey, 1987:481; Fazzari and Mott, 1986:171).

Several studies have challenged the neoclassical assumption that any desired investment project can be financed[2]. Asymmetric information[3] about the quality of a loan could lead to credit rationing, implying that not all borrowers seeking loans at the prevailing cost of capital may be able to obtain financing (e.g, Greenwald, Stiglitz and Weiss, 1984). Consequently, firms tend to rely on internal sources of funds to finance investment, and to prefer debt to equity if external financing is required[4].

A further theoretical development was the introduction of irreversibility and uncertainty in explaining investment behaviour. This literature demonstrates that the ability to delay an irreversible investment expenditure can profoundly affect the decision to invest (Dixit, 1989; Pindyck, 1991:1110). Firms have an incentive to postpone irreversible investment while they wait for new information which makes the future less uncertain (Bernanke, 1983; Cukierman, 1980).

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[2] See, for example, Fazzari and Athey, 1987; Greenwald, Stiglitz and Weiss, 1984; Kalecki, 1971:105-109; Minsky: 1975; Myers and Majluf, 1984.

[3] It has been argued that the separation of firm management from financing agents 'naturally creates asymmetric information' (Myers and Majluf, 1984:196).

[4] However, even when debt financing has tax advantages, firms will not use this source of funds exclusively, both because high interest commitments communicate negative information about a firm to lenders, and because of the risks attached to this form of financing, especially when interest rates and inflation are high (Harvey and Jenkins, 1994).

Studies of investment in developing economies

The development literature has long been concerned with investment, because of its importance for the rate of growth of *per capita* output in the economy (Dornbusch and Reynoso, 1989:204; Fei and Ranis, 1963:283; IMF, 1988). Although empirical models of the determinants of investment in developing countries are in broad agreement with results obtained for industrialised countries, there are additional factors which have been found to constrain capital accumulation. Most of these are related to the problem of uncertainty and/or risk, which acts as a disincentive to private investment, because of the irreversible nature of most investment expenditures (Pindyck, 1991).

Inflation reduces private investment by increasing risk, reducing average lending maturities, distorting the informational content of relative prices, and indicating macroeconomic instability (Dornbusch and Reynoso, 1989:206-208; Oshikoya, 1994:585,590). Empirical studies show that the variability of inflation has a stronger negative effect on private investment than does the level (see, for example, Serven and Solimano, 1993:137).

Large external debt burdens also have a strong disincentive effect on private investment, especially short-term debt (Faruqee, 1992:52). Debt-service payments reduce the domestic resources available for investment, and poor international creditworthiness reduces access to foreign savings[5]. For domestic investors, the existence of a large debt overhang reduces the future returns to investment because a high proportion of the forthcoming returns must be used to repay existing debt (Borensztein, 1990:315). A debt overhang is also a major source of uncertainty: the size of future transfers to creditors is uncertain; macroeconomic policy is uncertain; and the exchange rate is uncertain. The combined risks of changes in relative prices, taxation and aggregate demand reduces investment by both domestic and foreign entrepreneurs.

Whatever the cause, the irreversibility of real capital expenditures can result in underinvestment if the future is uncertain, even when current conditions are right (Tornell, 1990). During macroeconomic adjustment, the credibility of policy changes is an added problem (see Rodrik, 1989), and the possibility of policy reversal can have serious consequences for real private capital expenditures. Investors prefer to hold financial capital, which is easier to realise if conditions turn out to be adverse, and which retains the option to purchase real capital if optimism continues. For this reason, there are frequently long lags in the investment response to adjustment (Serven and Solimano, 1993:131,137).

Several studies report the effects of changes in the real exchange rate[6] and the terms of trade[7] on investment. These studies generally find that the variability of the real exchange rate is usually

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[5] Borenzstein suggests that the indirect credit rationing effect of large external debt may be a more powerful disincentive to private investment than the implicit tax effect of a large debt overhang (1990:316).

[6] On the supply side, a depreciation of the exchange rate would in theory have an ambiguous effect, reducing investment in the non-tradables sector, and raising it in the tradables sector, unless the sector is highly dependent on imported capital and intermediate goods. On the demand side, the effect is unambiguously contractionary, reducing private-sector real wealth and expenditure and, consequently, domestic demand.

[7] The terms of trade are an indicator of external circumstances. Declining terms of trade reduces incomes and profits in the export sector, inducing a fall in the rate of investment. If the current account worsens as a result, corrective adjustment policies would reduce investment in other sectors as well (Cardoso, 1993).

more of a disincentive for investment than is the level (for example, Serven and Solimano, 1993:137). Faruqee (1992:50, 52) disputes this finding for Sub-Saharan Africa, arguing that the level of the real exchange rate is significantly correlated with private investment. Oshikoya (1994:588) finds that the terms-of-trade effect is important for middle-income African countries, but not for low-income countries.

Finally, various studies use proxies for political instability, finding these to be significant (Bleaney, 1993; Garner, 1993; Root and Ahmed, 1979, Schneider and Frey, 1985). In his analysis of political uncertainty and private investment in South Africa, Bleaney finds that political uncertainty not only has a significantly negative impact on investment, but that the loss of investment is permanent rather than temporary (1993:9).

2.1.2 Determinants of foreign direct investment: theoretical developments

Early explanations of multinational production were based on neoclassical theories of international capital movements and trade within a Heckscher-Ohlin framework. However, these theories were unable to provide a satisfactory explanation of the nature and patterns of FDI, both because of the assumption of the existence of perfect factor and goods markets and because FDI differs in several important respects from other international capital.

If goods and factor markets were perfect, there would be little incentive for firms to undertake the risk and expense of establishing a foreign subsidiary. In order to overcome the cost of 'foreignness' (including lack of familiarity with the local environment, consumer preference for local brands, additional overheads and communications costs, the premium paid to expatriate managers, and sometimes unfavourable host country policies), there must be a distinct advantage to location abroad arising out of market imperfections.

The development of the theory of the multinational enterprise has followed two main approaches: location theory, which deals with the reasons underlying the choice of host country for overseas investment, and industrial organisation theory, which is concerned with successful competition between domestic producers and foreign firms.

In the latter case, the existence of firm-specific advantages are important in conferring a competitive edge on a foreign firm wishing to produce in rival markets at home and abroad (Hymer, 1976). These include advanced technology, R&D capabilities, superior managerial, administrative and marketing skills, access to low-cost funding (either internal to the firm or because of the firm's better credit rating), and interest- and exchange-rate differentials. Large firms with opportunities for economies of both scale and scope, and with more extensive marketing and distribution networks, will have additional firm-specific advantages. Kindleberger (1969) identifies four types of market imperfections in which these firm-specific advantages would provide a competitive edge: those arising from product differentiation, special skills and knowledge, and unequal access to resources and factors of production. Other imperfections are internal and external economies of scale that can be exploited through horizontal and vertical integration, and trade barriers.

Vernon (1966) argues that, within a given industry, some firms take the lead in product innovation, even if others have the same scientific knowledge. These products are developed first for the home market and are later exported. With time, competitors may challenge in domestic and foreign markets, and, if overseas production is economically feasible, production abroad may follow. Firms will also attempt to erect barriers to entry in their markets in order to protect an

oligopolistic position (Knickerbocker, 1973), or they will attempt to internalise markets in order to minimise market imperfections and external competition (Buckley, 1992). By internalising markets - for skills, raw materials, technology - firms reduce costs associated with transactions in external markets, offering protection against or opportunities to exploit market failure. An additional incentive for FDI will be the opportunity to control sources of production inputs or sales outlets which might otherwise be exploited by rival firms (Dunning, 1981:80-82).

Location-specific advantages offered by a host country include access to local and regional markets, availability of comparatively cheap factors of production, competitive transportation and communications costs, the opportunity to circumvent import restrictions, and investment incentives offered by the host country (reported in Cherry, 2001:10).

These two strands of thought were brought together in Dunning's 'eclectic' theory of international production, in which three types of advantage must exist for a firm to engage in FDI: ownership-specific, location-specific and internalisation-incentive advantages (Dunning, 1988).

Dunning (1993) identifies four main categories of motivation for investment abroad by multinational enterprises from industrialised countries: resource-seeking, market-seeking, efficiency-seeking and strategic asset- or capability-seeking. A firm may be influenced by more than one of these considerations, and the motivations for foreign production may change over time.

Resource-seeking investors will locate subsidiaries abroad to secure a more stable or cheaper supply of inputs, generally raw materials and energy sources, but also factors of production. The objective is to lower production costs and enhance competitiveness in domestic as well as foreign markets. Market-seeking investors attempt to defend market positions already established through exporting, or open up new markets for their goods and services in the host country and/or neighbouring countries. Typically these firms are seeking a way around trade restrictions or a reduction in production, transaction or transport costs. In some cases, the move abroad by a major client of a multinational company may prompt the investment in the interests of maintaining or expanding the existing business relationship. Efficiency-seeking investors attempt to rationalise their activities, aiming to produce in as few countries as possible, each with its own advantages in terms of location, endowments and government incentives, in order to service a larger number of markets. Finally, firms engaging in strategic asset-seeking investment do so in order to maintain and enhance the firm's international position, with less concern about the particular advantages of a specific host country.

2.1.3 The determinants of foreign direct investment in Africa: macroeconomic analysis

Efforts to generate economic recovery in Africa have generally given insufficient consideration to the need to encourage investment beyond a belief that 'better' policies should increase foreign capital inflows. It has been well documented that structural adjustment programmes adopted in compliance with donor conditionality have failed to reverse declining trends in investment, even in comparatively stable economies with a long history of adjustment. The World Bank (1994:124) has identified one of the main reasons for this

> Investment generally responds slowly to adjustment programs - in Africa and elsewhere ... This slow response is understandable. Governments cut capital spending as part of their fiscal stabilization, while the private sector adopts a wait-and-see attitude during the early phases of

adjustment, mindful of the irreversibility of investment decisions and the reversibility of key policy changes (indeed, policies have frequently been reversed in the past). The problem is particularly serious where there is no consensus about the importance of private-sector-led growth.

Although, in theory, it is possible to understand why multinational enterprises engage in FDI, the empirical question of why foreign firms locate subsidiaries in developing countries is not easily answered. In a review of empirical studies which examine the determinants of flows of FDI to developing countries, Asiedu (2002) finds that not only is there a variation in the factors counted to be important but different studies yield conflicting results with respect to the same factor.

For instance, Asiedu notes that GDP *per capita* is found to have a positive relationship with FDI in Schneider and Fry (1985), Tsai (1994) and Lipsey (1999); a negative relationship with FDI in Edwards (1990) and Jasperson *et al* (2000); and to be insignificant in Loree and Guisinger (1995), Wei (2000) and Hausmann and Fernandez-Arias (2000). Part of the reason for these different findings is that this variable can capture different effects. It can act as a proxy for returns on capital, based on the assumption that higher returns are available in poorer countries, with the implication that GDP per capita is inversely related to FDI. Alternatively, higher GDP per capita can imply better prospects for FDI in the case of market-seeking investment. Asiedu also finds that labour costs can have a positive impact on FDI (Wheeler and Mody, 1992); a negative impact (Schneider and Fry, 1985) and an insignificant effect (Tsai, 1994; Loree and Guisinger, 1995; Lipsey, 1999).

In Asiedu's review of the literature, only two variables are found to have an unambiguously positive effect on FDI: the quality of infrastructure (in Wheeler and Mody, 1992; Kumar, 1994; Loree and Guisinger, 1995) and openness to international trade (in Edwards, 1990; Gastanga *et al*, 1998; Hausmann and Fernandez-Arias, 2000).

In an empirical analysis of the determinants of FDI, Asiedu examines whether differences exist between the factors that influence direct investment in Sub Saharan Africa *vis-a-vis* other developing countries. She identifies the following list of variables:

- Return on investment in the host country, measured by the inverse of the real GDP *per capita*.
- Infrastructure development, measured by telephones per 1,000 population
- Openness of the host country, measured by the ratio of trade (imports + exports) to GDP
- Political risk, measured by the average number of assassinations and revolutions
- Financial depth, measured by the ratio of liquid liabilities to GDP
- Size of government, measured by the ratio of government consumption to GDP
- Overall economic stability, measured by the inflation rate
- Attractiveness of host country's market, measured by the growth rate of GDP

The empirical analysis reveals four differences. First, geographical location is an explanatory factor in low levels of FDI to Sub Saharan Africa. Second, higher returns on capital attract FDI flows to other developing countries but do not have a significant impact on FDI to Africa. Asiedu reasons that this is because the investment environment is more risky in Africa. Third, openness to trade has less impact on FDI in Africa than in other developing countries, and African countries have received lower levels of FDI in part because they are less open to trade. Asiedu suggests that trade liberalisation may be less effective in Africa, possibly because investors do not believe trade reform is credible. Finally, infrastructure development does not have a significant impact on FDI to Africa but encourages FDI to other developing countries. One explanation for this is the importance of natural resource investment in Africa; this type of investment is less dependent on existing infrastructure. (Asiedu, 2002)

In a study of FDI in Africa, Ngowi (2001) points out that it is difficult to determine the exact quantity and quality of each of the determinants of FDI that should be present in a location for it to attract a given level of FDI inflows. Nevertheless it is possible to identify factors that all firms are believed to consider when deciding whether or not to invest in a particular country. Ngowi cites the following:

- A stable and predictable political environment
- Favourable macroeconomic indicators, for example, good performance on economic growth, stable inflation rates, low budget deficits
- The quality of infrastructure, roads, communication networks, transport networks, electrical power
- The availability and quality of natural resources
- The size, openness and competitiveness of the domestic market
- Well functioning and transparent financial markets
- Qualified human capital, low cost, unskilled labour may be an influential determinant, depending on the nature of the prospective FDI
- Low transactions and business costs, including trade and labour regulations, rules of entry and exit into markets, favourable tax structures
- An efficient and dependable legal system

Ngowi then concludes that, with respect to African countries, the main factors preventing an increased inflow of FDI are that most countries are regarded as high risk and are characterised by a lack of political and institutional stability and predictability. Additional factors that are cited as hindrances to prospective FDI include poor access to world markets, price instability, high levels of corruption, small and stagnant markets and inadequate infrastructures.

In another study of the effect of policy on FDI in Africa, Morrisset (2000) suggests that it is useful to look at those countries that have been attracting FDI successfully over the past few years when they could not rely on abundant natural resources and the size of the domestic market (the historic motivations). A variable measuring the business climate for FDI is constructed (by normalising the value of total FDI inflows by GDP and the total value of natural resources in each country). According to this index, of the 29 African countries in the sample, Namibia, Mali and Mozambique were found to be the most attractive locations for FDI in 1997 and 1998.

In attempting to determine what makes the FDI business climate attractive in Africa, a range of variables were used in the regression analysis, including, amongst others, GDP growth, illiteracy rates, the ratio of trade to GDP, telephone mainlines per 1,000 people and the ratio of urban to total population. These variables are similar to those used in the work reviewed above. Morrisset finds that the most important features of countries successfully attracting FDI are strong economic growth and aggressive trade liberalisation. Other important factors include privatisation programmes, the modernisation of mining and investment codes, the adoption of international agreements relating to FDI, a few large priority projects which have significant multiplier effects, and a high-profile image-building exhibition involving the head of state.

2.1.4 Determinants of foreign direct investment: survey-based analysis

In addition to the macro-level analysis reviewed above, there have been several survey-based studies in recent years analysing the barriers to investment in developing and transitional economies. In this section, we discuss a small selection of these studies in order to illustrate the different approaches used to assess a range of research questions. Survey-based studies on FDI in Africa have tended to focus on barriers to investment. We also discuss a survey-based study

of FDI in Eastern Europe which broadens this focus to look at the characteristics of foreign-owned enterprises.

Eastern Europe

Lankes and Venables (1997) reports the findings of a survey of 117 Western European firms with investments in Eastern Europe. The objective of this study was to examine how the characteristics of FDI vary across the transitional economies and to analyse the reasons why firms undertake FDI. The purpose is to shed light on the relative success and failure of countries in attracting FDI and to assist policymakers in designing policy towards encouraging FDI.

They find that there are at least two distinct motives for undertaking FDI: market access and production costs (pp.345-6). The former derives from the gain of being close to consumers and tends to be associated with distribution outlets and/or production purely for the local market. The second arises from the benefits of being able to base production in low-cost locations and tends to be correlated with export orientation. Projects dependent on lower production costs were found to be more footloose, replacing or displacing production elsewhere in the world, more closely integrated in the overall activities of the firm, and somewhat more upstream.

They also find that the choice of control mode depends on internal requirements. Joint-venture projects are associated with the need to gain access to local contacts and information. Wholly-owned projects tend to be preferred where firms need to safeguard technology and product quality, and tend to be more export-oriented and to have more of their output transferred within the firm.

The most important country-specific factors are found to be progress with economic transition and perceived risk levels. These affect both the overall level of FDI inflows and the characterstics of the investments undertaken. In countries which were perceived to have better policies and lower risks, firms are less likely to postpone or abandon projects, and more likely to establish export-oriented projects. It is also more likely that the projects will be vertically integrated in the firm, and more likely that firms will exploit comparative advantage in the host economy. The authors reason that this is because these projects are more sensitive to interruption of supply: whereas horizontal investments tend to replicate activities, vertical investments tend to involve relocation, leaving the firm vulnerable if supply is interrupted.

With respect to the welfare implications of FDI, they suggest (rather than establish) that greater economic benefits come from firms located in more outward oriented countries, as they are more likely to bring with them the benefits of technology transfer, quality control and the development of marketing channels. In other words, it is the nature of host-country economic policies which ultimately determine the benefits derived from FDI (Lankes and Venables, 1997).

Findings from surveys in Africa

In an review of survey-based evidence, Hess (2000) assesses the investment climate in each of the SADC economies, and highlights the most common factors acting as a constraint to investment. There are no surprises - indeed, much of the survey work undertaken in recent years points to the same set of barriers as an explanation for the continued low share of foreign direct investment in Africa. The five most important barriers identified by Hess are:

- unstable political and economic environments;

- inefficient and cumbersome bureaucracies, which can breed corruption;
- a lack of transparency;
- inadequate infrastructure, most notably for telecommunications, transport, and the provision of electricity and water;
- high taxation.

In addition, further weaknesses associated with one or more economies in the region are:

- weak private sector institutions
- visa requirements and availability of work/residence permits
- underdeveloped financial sectors
- differing product standards
- small domestic markets
- shortages of skilled labour
- low productivity
- archaic legislation
- uncertain or restricted land ownership

Hess emphasises the need for policy coordination in attracting FDI. He argues that the most important factor in attracting significant levels of foreign investment is a stable macroeconomic and political environment. He notes that investors require as much certainty as possible about the direction of the economy; interview evidence reveals a preference for slightly less-than-optimal but predictable policies over optimal policies that may be reversed (Hess, 2000).

Mowatt and Zulu (1999) reports the findings of a survey of South African firms investing within Eastern and Southern Africa. They find that regional (in this case, South African) investors are generally informed about the different economic conditions that exist across the region. For instance, South African investors rated the economic policy framework highly in Botswana, Mozambique and Namibia but poorly in Zimbabwe. Financial factors such as exchange controls, depreciation and high interest rates, are a barrier in Zimbabwe and, to a lesser extent, in Mozambique but not in Botswana and Namibia. On the other hand, transport infrastructure in Zimbabwe is rated highly, not so for Mozambique. Some studies have suggested that regional investors are more positive about investing in Africa than their international counterparts. While part of the explanation probably lies in the benefits of familiarity, it may also be the case that there is some difference between the quality of information available to investors within the region compared to those overseas (CREFSA-DFI, 2000).

Findings from surveys of regional investors within Eastern and Southern Africa are described in CREFSA-DFI (2000). This paper summarises the findings from country studies in Mozambique, Tanzania, Uganda, Zambia and Zimbabwe. Investor perceptions surveys aimed at identifying the most important factors shaping opinions on the investment climate in these countries were carried out by teams of officials from a range of institutions. A complementary survey of the perceptions of South African investors of the investment climate in the region was also carried out (described in Mowatt and Zulu, 1999). In general, investors in these countries tended to highlight commitment to liberalisation and general macroeconomic stability as positive factors in driving investment decisions. In contrast, negative factors for some of these countries included exchange rate instability and inflation; unreliability of infrastructure; and weak governance.

Finally, the Africa Competitiveness Report (World Economic Forum, 1998) points to corruption as a key concern of foreign investors, in addition to political and policy instability, high and complex taxes, and the quality of infrastructure. The UNCTAD World Investment Report (1999)

reports the findings of a survey of African investment promotion agencies on the prospects for foreign direct investment. The factors most frequently mentioned as having a negative influence on investment are extortion and bribery, high administrative costs of doing business and access to capital.

2.2 The developmental effects of FDI

It is clearly desirable to be able to measure the response of the economy and consequent changes in household living standards arising from changes in FDI. However, a complex chain links changes in investment (or any other macroeconomic variable) to impacts on households. There is no comprehensive analytical model of this process, which makes it necessary to address aspects of the chain, identifying those theories which are relevant to key parts of the problem in order to explore the links.

2.2.1 General welfare effects of FDI

Existing research shows that the most important factor in shifting poor people out of poverty is access to employment, especially formal-sector employment. Although this is generally true, a large number of studies establish the point specifically for countries in Southern Africa; for example, Jenkins and Knight, 2002; Johnson and Sender, 1995; Knight and Kingdon, 2000; Leibbrandt *et al*, 1999; Seekings, 1999; Wilson and Ramphele, 1989. Insufficient job opportunities are the result of inadequate levels of investment, both domestic and foreign.[8] Low investment also makes other forms of poverty alleviation more difficult, because rates of economic growth below the rate of increase in the population means that each year more people are *added* to the ranks of the poor.

Domestic and foreign investors are potential sources for both private- and public-sector capital formation (Saravanamuttoo, 1999:3). Generally, poorer countries have insufficient domestic resources available to meet their investment needs. Low domestic saving is often attributed to, amongst other factors, low *per capita* incomes; high and often fluctuating inflation rates; low export-to-GDP ratios, and poor financial intermediation (UNECA, 1995:2). While there is limited scope for poor countries to increase domestic savings, any increase that there may be is unlikely to be sufficient to meet total investment requirements. Foreign investment is needed to reduce the gap between desired gross domestic investment and domestic savings.[9] Long-term capital inflows, whether direct investment or long-term loan and portfolio capital, are evidently desirable. FDI has advantages other than constituting simultaneously a source of funds and foreign exchange, and these are discussed below.

Little empirical evidence exists regarding what effect FDI has had on development and poverty reduction for Africa. While there is general consensus that FDI is no panacea, it is widely believed that FDI can deliver many of the potential benefits discussed below, *provided* that mechanisms

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[8] Of course the relationship is more complex than this. Investment is not always of a form appropriate for significant employment creation, and increasing capital intensity in production may lead to fewer job opportunities in the context of economic growth. However, generally speaking, low levels of investment result in low rates of job creation, and high investment has an accelerator effect on domestic investment and on economic growth.

[9] Neo-classical growth models stress the importance of physical investment in driving more rapid expansion of output, and the correlation between the rate of investment and the rate of growth of output is strong in all studies that analyse the determinants of economic growth (Sala-i-Martin, 1997). This is particularly true of equipment investment (rather than buildings and infrastructure).

are in place in the host country to ensure that these benefits are appropriated.[10] The net effect is likely to depend on domestic circumstances.

2.2.2 FDI and economic growth

While economic growth is not synonymous with economic development, it is at least necessary. Provided that mechanisms exist to facilitate some trickle-down of the benefits of economic growth to the impoverished, economic growth can aid in poverty reduction. FDI rarely has direct effects on welfare (except, at the micro level, where firms engage in corporate social responsibility programmes, providing schools and medical facilities for employees and their families). The most important mechanism by which trickle-down occurs is via employment-creating economic growth. In this way it is possible that, if FDI serves as a catalyst for economic growth, it will stimulate development and contribute to alleviating poverty.[11]

Macro-analyses of economic growth frequently include a variable for inflows (or the stock) of FDI, finding it to have a positive effect on growth. However, there are obvious simultaneity problems in this type of work. In a paper that specifically addresses simultaneity, Lipsey (2000) finds that trade openness is the single-most important determinant of FDI inflows, and that the ratio of FDI to GDP is the most consistent positive influence on subsequent growth rates.

FDI is expected to contribute to economic growth not only by providing foreign capital but also by crowding in additional domestic investment. By promoting both forward and backward linkages with the domestic economy, additional employment is indirectly created and further economic activity stimulated. In a study of 58 developing countries, including several in Africa, Bosworth and Collins (1999) finds that FDI brought about a 'one-for-one increase in domestic investment' compared to other types of private finance which are inclined to finance consumption (see also Loungani and Razin, 2001). In addition, FDI may provide access to new overseas markets (discussed below), and may also serve to improve efficiency in existing markets by promoting increased competition and, thereby, enhancing productivity (Cotton and Ramachandran, 2001). 'Herding' may enhance these benefits: Hanson (2001) has suggested that FDI tends to agglomerate in areas where there are already many foreign companies present. In this regard, FDI may encourage future foreign investment by increasing prospective investors' confidence in a particular region (see also Jacobs, 2001).

Despite the potential of FDI to enhance growth, it remains a concern that the monopolistic tendencies of foreign subsidiaries may crowd out domestic investment (Gardiner, 2000). Increased rivalry between domestic and foreign firms could be beneficial in terms of promoting competition, improving efficiency amongst inefficient firms, and ensuring the most productive allocation of scarce resources. However, FDI may equally 'crowd out' domestic firms and result in a contraction in total industry size and/or employment (Cobham, 2001; in Jacobs, 2001). Often domestic firms are incapable of successfully competing with foreign firms, which have superior marketing and advertising power, tend to be oligopolistic, and are able to engage in predatory pricing to restrict prospective entrants from gaining access to the market. Nevertheless, the literature concedes that crowding out is the more rare event, and that the benefits of FDI tend to

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[10] Moran (1998, cited in Pigato, 2000), reviews approximately 200 FDI projects in 30 African countries and finds that up to 45 percent of the projects had negative welfare implications for the host countries concerned.

[11] The process of trickle-down is slow and untargeted. Government intervention may be needed to redistribute at least some of the benefits of growth to the poor.

be more prevalent, especially enhanced competition, improved efficiency and increased innovation (Cotton and Ramachandran, 2001:1).

2.2.3 FDI, job creation and technology transfer

A key developmental spillover is local job creation. Aaron (1999) indicates that in 1997 it was likely that FDI was directly responsible for 26 million jobs in developing countries worldwide. In addition, for every one direct job created by FDI it was estimated that approximately 1.6 additional jobs were indirectly created. If FDI serves to multiply job opportunities in host countries, this will help to address unemployment and raise wages, as well as encourage investment in human capital through the transfer of skills and knowledge to the local workforce via both on-the-job and specialised training. However, some (now relatively old) studies of Kenya show that FDI made a modest contribution with regard to direct employment creation (Nzomo, 1971), while the ability to develop managerial skills was negligible (Kim, 1985; see also Pigato, 2000).

Often FDI is attracted to those developing countries where there is a surplus of low-cost labour, as well as a labour force that is highly skilled and literate. Borensztein, De Gregario, and Lee (1998) find that FDI increases economic growth when the level of education in the host country - a measure of its absorptive capacity - is high. Moreover, FDI appears regularly to be a key source of employment for women in developing countries. If this is indeed the case, the implications for poverty alleviation are important: research has shown that the earnings of women are most often allocated to improving the health and nutritional well-being of their children, and any increase in women's employment and/or increases in their wages are likely to improve the quality of life in households where women work (Cotton and Ramachandran, 2001).

FDI is generally associated with facilitating the transfer of newer, faster and more productive technology to developing countries. Productivity may be raised through enhanced worker training, improved management techniques, and the use of more sophisticated and efficient technology. While improved technology, new innovations and knowledge may be transmitted through other means, for example, from the importation of capital goods and through licensing agreements, FDI is seen as more comprehensive since it 'tends to package and integrate elements' from the various methods (Klein *et al*, 2000:3-4). However, a study by Cockcroft and Riddell (1991) suggests that FDI made a negligible contribution to productivity in most African countries during the 1980s.

If technical, entrepreneurial and management skills are scarce, the training of local personnel to fill senior positions brings about an important diffusion of these skills. One way in which skills (as well as income and wealth) may be transferred from foreign firms to locals is via joint ownership of assets: if foreign firms permit domestic investors to hold a share of the equity, human capital is diffused as well as profits being distributed. On the other hand, if management positions are filled by expatriates, skills diffusion is less likely to accrue to the host country.

It appears that whether or not any improvements in technology are actually realised from FDI depends critically on the policy and performance of the foreign firms, the receptiveness of the host country to technological advancements, and the way in which domestic factor markets work.

There also is concern that while FDI does bring with it knowledge, superior technology, and new innovations, many of these 'benefits' are not suitable for use in labour-abundant developing countries. Capital-intensive FDI may fail to create many jobs. A 1985 survey of subsidiaries of multinational corporations in South Africa revealed a tendency for foreign firms to adopt an

increasingly capital-intensive mode of production, using technologies developed abroad (Jenkins, 1986:124). The reasons given for this trend were (i) increased efficiency; (ii) lower unit costs; (iii) a shortage of skilled labour and therefore a need to use labour-saving techniques; (iv) reduced dependence on increasingly expensive and militant labour; (v) the lack of alternative production methods (in new industries or for new products); (vi) a tendency for the parent company and its subsidiaries to use uniform production techniques all over the world; and (vii) the need to preserve international standards of quality. Most firms surveyed acknowledged that both technology and new products were almost exclusively developed abroad with other markets in mind.

Even if FDI does succeed in creating employment, income inequality may become more skewed: 'where employment and training is given to more educated, typically wealthy elites, or there is an urban emphasis, wage differentials (or dual economies) between income groups will be exacerbated' (Gardiner, 2000), and inequality between groups may worsen. This is most likely to occur where foreign investment is found in enclaves in an otherwise underdeveloped economy, as is the case in the oil industry in Angola.

2.2.4 FDI and standards for environmental and labour practices

It is argued that FDI can contribute to a 'race to the bottom', in that countries lower their environmental and labour standards to prevent a loss of investment and employment. In Tanzania, for example, new investment codes promulgated to attract FDI were argued to be detrimental to host country interests. These included 'generous tax holidays, free and unencumbered transfer of profits, scrapping of job protection provisions and pension scheme contributions (to create a 'flexible labour market') and freedom from social and environmental regulations deemed to make companies and economies uncompetitive' (Lissu, 1999).

However, there is little conclusive evidence to support the 'race to the bottom' hypothesis. Large firms can be instrumental in raising standards of environmental and labour practices in developing countries, because they have a corporate employment policy, in order to preserve their reputation globally, and to avoid, in some cases, the risk of boycotts by consumers in wealthy countries.[12] For similar reasons, foreign investors are now increasingly seen to adhere to international environmental standards more often than domestic companies, and sometimes are instrumental in introducing modern environmentally friendly technology to the host countries (BIAC, 1999; Aaron, 1999; Cotton and Ramachandran, 2001).

2.2.5 FDI and tax revenue

Taxation of foreign subsidiaries raises government revenues. This in turn can be used to fund various social development programmes (Aaron, 1999). On the other hand, where corporate tax rates are particularly high, there may be a case for lowering rates in order to bring them into line with those prevailing elsewhere, so as not to deter foreign investment. Internationally compatible corporate tax rates should reduce incentives to engage in 'transfer pricing'[13], a practice which

[12] Public scrutiny of employment practices by foreign multinationals operating in South Africa in the 1970s and 1980s was instrumental in these subsidiaries' being more progressive than local firms in all aspects of worker rights (Jenkins, 1986:127-130).

[13] Where multinational firms use the pricing of intra-firm transactions to affect profit declared, and therefore tax paid, in host and source economy.

reduces tax revenue in the host economy (although difficulties - real or perceived - in repatriating profits provides additional motivation to engage in transfer pricing). Whether or not government budgets gain sufficiently from taxing foreign subsidiaries depends on what policies and agreements are in place to ensure that tax revenue and/or royalties are collected.

The use of transfer pricing by foreign firms to minimise tax burden has been criticised elsewhere. UNCTAD (1999:166) notes that reforms to restrictions on profit remittance and double taxation treaties should have reduced the use of transfer pricing to withdraw income from the host economy. But UNCTAD argues that this issue remains a concern for developing countries. For instance, in a study conducted by UNCTAD, 84 percent of developing countries participating in a survey believed that affiliate companies hosted in their economy shift income to parent firms in order to reduce tax liabilities. It is concluded that transfer pricing continues to be an issue, with action required at both the national level and in the context of international investment arrangements.

2.2.6 The form of FDI

The form in which FDI occurs may influence the extent to which the host country benefits from the presence of foreign-owned firms. A significant proportion of worldwide FDI in the past decade, to developing as well as developed countries, has been in the form of mergers and acquisitions, as opposed to greenfield investment. The *World Investment Report 2000* (UNCTAD, 2000) explores many of the concerns associated with the impact of acquisitions by foreign companies in developing countries. These include the view that acquisitions do not necessarily add to productive capacity (in contrast to greenfield investment, where aggregate economic activity necessarily increases); the observation that a change in ownership frequently has an adverse impact on employment and production, which may actually decline as rationalisation takes place in the case of acquisitions; the possibility of market dominance of strategic sectors by new foreign owners; and the possibility of reduced competition as domestic firms are eliminated. UNCTAD concludes that, in the short term, acquisitions may have fewer benefits (or larger costs) than greenfield investment for the host country. Nevertheless, it is argued that what matters more for developmental impact in the longer term is the 'motivation' for foreign investment. For instance, not all acquisition is motivated by a desire to eliminate domestically-owned competitors in a particular market, and subsequent investment for expansion or modernisation, with potential gains for output and employment, can happen regardless of the initial method of entry into an economy.

Greenfield investment and acquisitions are not always substitutes. One relevant area where acquisition is by definition necessary is in the case of privatisation. This type of acquisition can be particularly important in modernising strategic industries, and, in some circumstances, in supporting firms that would otherwise fail in the absence of new financing. Even here, however, political issues of national sovereignty are often raised, although these arguments are more concerned with the general presence of foreign firms in an economy - and can equally be applied to many types of greenfield investment[14]. At any rate, the assumption of ownership of enterprises by foreign firms can combine elements of both acquisition and greenfield investment, as when

[14] There has been sensitivity, especially in Africa, to issues of national autonomy, which is believed to be threatened by foreign economic power. There are undoubtedly examples of foreign firms which have exerted considerable influence over policy-makers, and, as a group, foreign-controlled firms are potentially a very powerful lobby. In practice, many firms prefer to avoid political involvement, particularly when the political situation is tense: this was found to be the case in South Africa in the mid-1980s (Jenkins, 1986:135) and was also reportedly the case in Zimbabwe in the late 1990s (see Jenkins and Knight, 2002).

significant new investment takes place at the same time as acquisition. In this case, the distinction between the two is not always obvious.

2.2.7 FDI and access to international markets

Foreign firms have the ability to improve the access of the host country to international markets, since many are well connected globally in terms of access to financial markets, consumer outlets and transportation networks. Research has shown that foreign firms can act as 'catalysts' for domestic exporters by providing externalities that augment the exporting prospects of domestic firms. Foreign firms may be seen as 'natural conduit[s] for information about foreign markets, foreign consumers, and foreign technology, and they provide channels through which domestic firms can distribute their goods' (Aitken *et al*., 1997:105). This raises a country's potential to increase foreign-exchange earnings from exports for purchasing imports and servicing debt.

2.2.8 FDI and regional integration

Finally, within any group of countries, there is the concern that the dominant member will attract FDI at the expense of its smaller neighbours. This is particularly relevant in the case of Southern Africa, where smaller economies are concerned by the possibility of increased domination of South African trade and investment, and of losing foreign investment to South Africa. This fear is not unreasonable, and it will become more of a problem with the formation of a regional free trade area. International experience suggests that the benefits from regional trade integration (in terms of both trade volumes and new inward investment) tend to flow disproportionately to the larger partners to the agreement, and the emergence of a few poles of industrialisation should be expected (Jenkins, 2000:141). This raises the political argument that some mechanisms to encourage reverse capital flows should be part of a free trade agreement in order to spread the gains from regional trade.

2.3 Conclusions from the literature

2.3.1 The determinants of foreign direct investment

Determinants of private (domestic and foreign) investment

Private investment is stimulated by demand relative to capacity, subject to financial constraints. The development literature that deals with private capital formation is deeply concerned with the issue of uncertainty and risk as disincentives to investment, because of the irreversible nature of most capital expenditure. Macroeconomic instability is a significant discouragement as is the presence of large external debt burdens. The variability of both the exchange rate and the rate of inflation - more than their levels - causes investors to hesitate to commit significant resources. Uncertainty about the future will dominate decision-making, even when potentially profitable opportunities exist. For this reason, investment in liquid instruments is preferred to direct investment during macroeconomic adjustment, and the lags in the investment response to adjustment are very long. Political uncertainty exacerbates perceptions of a fragile investment climate.

Determinants of foreign direct investment: theoretical developments

Without market imperfections, FDI would not take place. The presence of risks in investing abroad implies that there must be distinct advantages to locating in a particular host country,

although ownership-specific advantages and the internalisation of otherwise external markets also play a role. Multinational enterprises may base FDI decisions on one or more of the following factors: a secure and cheaper source of regularly required inputs; the desire to defend or expand markets or service existing clients in a particular foreign region; the wish to rationalise production into a network of the most efficient production bases supplying the largest possible worldwide market; and other strategic considerations with respect to the firm's international position.

Determinants of foreign direct investment in Africa: macroeconomic analysis

The indicators which have been found most frequently to be correlated with increased FDI in Africa in cross-country macroeconometric analyses are: economic openness, especially to international trade; the quality of institutions and physical infrastructure in the host economy; and economic growth and stability.

Determinants of foreign direct investment: survey-based analysis

Investor surveys in Africa and elsewhere have tended to indicate the importance of governance and stability in promoting investment. For Eastern Europe it appears that the policy framework and progress with economic reform has been a consideration in establishing export-oriented subsidiaries which are integrated into the firm's global production strategy. For Africa, economic instability and institutional weaknesses tend to be most often identified as barriers to increased levels of FDI.

2.3.2 The developmental effects of FDI

In order for developing countries, including those in Africa, to reduce unemployment and poverty, economic growth is necessary (but not, in itself, sufficient). Because many developing countries are characterised by low levels of domestic savings, it is unlikely that most will be able to achieve the required levels of domestic investment to finance rapid rates of economic growth. Therefore, foreign capital, especially in the less volatile form of FDI, is required.

The evidence on the welfare benefits of FDI is mixed. Possible developmental benefits include employment creation, the promotion of forward and backward linkages in the host economy, the development of human capital, the implementation of internationally acceptable codes of employment practice, improving the access of the host economy to world markets, and augmenting corporate tax revenues. But these benefits are not automatic, and mechanisms may be required to ensure that the expected benefits of FDI are equitably distributed in order to make a positive impact on poverty alleviation and social welfare.

The analysis of the full range of potential welfare impacts of FDI in Southern Africa is beyond the scope of this study. The following subset of issues are explored in section 4 through the survey of parent companies.

- output growth and employment
- economic sector, growth and employment
- method of entry, local ownership and employment
- access to intenational markets
- the tendency for FDI to concentrate in South Africa at the expense of its smaller neighbours

3. FDI in Southern Africa: an overview

3.1 The macroeconomic context

Table 3.1 records the rates of aggregate (gross domestic) investment, gross domestic savings, foreign direct investment, foreign aid and economic growth for each SADC member country during the 1990s. The difference between gross domestic investment and gross domestic savings is the resource gap, and developing countries can fund an excess of investment over domestic resources by attracting foreign capital inflows.

Table 3.1: Sources of investment, percent of GDP, average for 1990-99

	Investment[1]	Domestic savings	Foreign capital			GDP growth (%)
			FDI	Aid	External debt[2]	
Angola	*13.4*	*19.3*	*5.7*	*5.4*	157.8	0.4
Botswana	26.0	33.7	0.3	2.4	13.3	4.3
DR Congo	*7.0*	*8.5*	0.0	*4.0*	178.2	-5.1
Lesotho	*57.2*	*-39.4*	*13.9*	*14.4*	69.5	4.4
Malawi	17.3	3.0	1.3	26.1	114.9	3.8
Mauritius	28.3	24.0	0.8	1.2	44.4	5.1
Mozambique	19.8	-6.6	2.7	39.8	238.3	6.2
Namibia	21.7	9.3	*3.3*	5.7	*12.9*	3.4
Seychelles	31.5	22.3	6.8	4.3	35.2	3.3
South Africa	14.8	17.6	0.6	0.3	17.5	1.9
Swaziland	24.8	21.7	5.3	4.2	22.8	3.1
Tanzania	21.4	1.8	1.3	18.8	127.6	2.8
Zambia	14.1	7.1	3.5	24.5	201.3	0.2
Zimbabwe	19.7	16.9	1.3	5.9	60.3	2.8

Source: *World Development Indicators 2001* CD ROM, World Bank
Notes: Numbers in italics indicate that the reported average has observations missing from the calculation.
1. Gross capital formation
2. Stock of external debt to GDP

Average savings ratios of less than 10 percent are recorded in half of the SADC members, while only four countries have savings rates in excess of 20 percent. This compares to an average for low and middle income countries of 25 percent in 1999. FDI or long-term loans are the most sustainable method of absorbing foreign savings over a long period of time. Most Southern African countries plug the savings gap by absorbing foreign aid: loans at concessional rates of interest. During the 1990s, annual aid inflows have been, on average, larger than FDI inflows for 10 of the 14 SADC members. It is no coincidence that aid-dependent countries also have high external debt-to-GDP ratios. Annual aid inflows as a percentage of GDP have been highest for Malawi, Mozambique, Tanzania and Zambia; these countries also have an external debt burden averaging more than 100 percent of GDP.

It is evident from Table 3.1 that, in comparison to aid flows, inflows of FDI are not a significant source of investment funds for many of the SADC members. Those members which do attract larger than average ratios of FDI tend to be countries with significant natural resources which are not exploited by local firms. Given the small contribution of FDI to funding the resource gap for many of these countries, it is unlikely that rates of economic growth and FDI will show any significant correlation, although FDI is only one of several factors identified in the literature as being correlated with growth in cross-country studies. It is clear from the table that low levels of net FDI inflows during the 1990s are not necessarily associated with slow economic growth, as appears to be the case for Botswana and Mauritius; nor are relatively large inflows necessarily associated with rapid economic growth, as in Angola and Zambia.

3.2 FDI to Southern Africa in a global context

Around 80 percent of FDI to developing countries is received by the East Asian and Latin American regions (Table 3.2). This share has been roughly constant through the 1990s, although towards the end of the 1990s, Latin America became the preferred destination, in contrast to the first half of the 1990s when flows to East Asia dominated. Sub-Saharan Africa's share of total FDI to the developing countries has generally remained between just 3 to 5 percent of the total over this period, indicating the marginalisation of the continent in terms of attracting this key source of long-term private capital. For the SADC economies, the approximate share of total FDI varied between 2 and 3 percent between 1995 and 1999.

Table 3.2: Foreign direct investment in low & middle income countries: percentage of total net inflows

	1995	1996	1997	1998	1999
Low & middle income	100.0	100.0	100.0	100.0	100.0
East Asia & Pacific	49.7	46.4	38.0	35.8	30.2
Europe & Central Asia	15.8	12.2	13.6	14.1	14.3
Latin America & Caribbean	27.8	33.0	37.7	40.8	48.7
Sub-Saharan Africa	4.3	4.0	4.8	3.6	4.3
SADC	**2.6**	**1.6**	**3.1**	**1.9**	**2.7**

Source: Calculated from data in World Development Indicators, 2001 CDROM, World Bank

Table 3.3: Foreign direct investment in low & middle income countries: net inflows, in US$mns (nominal)

	1995	1996	1997	1998	1999
Low & middle income	106,990	131,451	172,571	176,764	185,408
East Asia & Pacific	53,143	61,029	65,577	63,297	56,041
Europe & Central Asia	16,906	16,087	23,544	24,997	26,534
Latin America & Caribbean	29,781	43,320	65,139	72,052	90,352
Sub-Saharan Africa	4,635	5,212	8,317	6,294	7,949
SADC	**2,735**	**2,040**	**5,363**	**3,409**	**5,039**

Source: World Development Indicators, 2001 CDROM, World Bank

3.3 FDI in Southern Africa: country experience

The available data indicate that the experience of SADC countries in attracting long-term capital flows has been mixed. Table 3.4 provides data on FDI to SADC as a percentage of GDP, compared to a selection of other emerging and developing economies. While in US dollar terms, the FDI received by SADC countries is small (Table 3.3), because of the small size of many of these economies, inflows as a percent of GDP have been, at times, quite high relative to other developing economies. These inflows are often explained by a relatively small number of large transactions and tend to occur in countries where there are unexploited natural resources.

Table 3.4: Foreign direct investment: net inflows as percent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Angola	-3.3	5.5	5.0	5.7	4.2	9.1	2.4	5.4	17.3	28.9
Botswana	2.5	-0.2	0.0	-6.9	-0.3	1.4	1.4	2.0	1.9	0.6
DR Congo	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	..
Lesotho	2.7	1.1	0.4	1.8	2.2	29.5	30.6	26.2	30.2	18.7
Malawi	0.0	0.0	0.0	0.0	0.8	1.7	1.8	0.9	4.0	3.3
Mauritius	1.6	0.6	0.5	0.5	0.6	0.5	0.9	1.3	0.3	1.2
Mozambique	0.4	0.9	1.3	1.5	1.5	1.9	2.5	1.8	5.4	9.7
Namibia	*1.2*	*4.7*	*4.0*	*2.0*	*3.2*	*4.6*	*4.0*	*2.8*	*2.9*	..
Seychelles	5.4	5.3	2.1	4.0	6.1	7.9	5.9	10.0	10.3	11.0
South Africa	*-0.1*	*0.2*	*0.0*	*0.0*	0.3	0.8	0.6	2.6	0.4	1.0
Swaziland	3.5	9.4	9.0	7.3	6.0	4.1	1.8	-1.2	10.2	2.7
Tanzania	0.0	0.0	0.3	0.5	1.1	2.3	2.3	2.1	2.0	2.1
Zambia	6.2	1.0	1.4	1.6	1.7	2.8	3.6	5.3	6.1	5.2
Zimbabwe	-0.1	0.0	0.2	0.4	0.5	1.7	0.9	1.6	6.6	1.1
Brazil	0.2	0.3	0.5	0.3	0.6	0.7	1.4	2.4	4.1	4.3
Chile	1.9	2.4	2.2	2.3	5.1	4.5	6.8	6.9	6.4	13.7
Mexico	1.0	1.5	1.2	1.1	2.6	3.3	2.8	3.2	2.7	2.4
Peru	0.2	0.0	0.4	2.0	6.9	3.8	5.8	3.0	3.3	3.8
Indonesia	1.0	1.2	1.3	1.3	1.2	2.2	2.7	2.2	-0.4	-1.9
Malaysia	5.3	8.1	8.8	7.5	5.8	4.7	5.0	5.1	3.0	2.0
Philippines	1.2	1.2	0.4	2.3	2.5	2.0	1.8	1.5	3.5	0.7
Thailand	2.9	2.1	1.9	1.4	0.9	1.2	1.3	2.6	6.5	5.0
Czech Rep.	0.6	2.3	3.7	1.9	2.1	4.9	2.5	2.4	4.9	9.6
Hungary	0.0	4.4	4.0	6.1	2.8	10.1	5.0	4.7	4.3	4.0
Poland	0.1	0.4	0.8	2.0	1.9	3.3	3.4	3.3	4.0	4.7
Romania	0.0	0.1	0.3	0.3	1.2	1.3	0.8	3.8	4.9	3.1

Source: World Development Indicators, 2001 CDROM, World Bank and International Financial Statistics Yearbook 2001, International Monetary Fund (italicised)

Direct investment inflows into SADC in US dollar terms have been largely dominated by Angola and South Africa in the second half of the 1990s (Table 3.5).

Table 3.5: Foreign direct investment: net inflows, in US$mns (nominal)

	1995	1996	1997	1998	1999
SADC	**2,735**	**2,040**	**5,363**	**3,409**	**5,039**
Angola	472	181	412	1,114	2,471
South Africa	1,248	816	3,811	550	1,376

Source: World Development Indicators, 2001 CDROM

While inflows into South Africa in US dollar terms are high by regional standards, they represent only a small fraction of GDP, in contrast to other large emerging market economies (Table 3.4). Expectations of significant inflows of FDI following the political transition in South Africa in 1994 have not been realised. In recent years, annual inward direct investment has exceeded one percent of GDP only twice - in 1997 and 1999. On both occasions, privatisation transactions were important. In contrast, inward portfolio investment averaged more than 8 percent of GDP between 1997 and 1999 but declined dramatically in 2000 and 2001. Surges and reversals of foreign investment in the domestic bond market have been a particular source of volatility.

Angola has attracted huge amounts of foreign direct investment in recent years, although inflows have been volatile. FDI amounted to 17 percent of GDP in 1998 and 29 percent in 1999. This consists largely of investment in the oil and natural gas sector, which is arguably relatively insulated from political and economic instability.

The relatively high levels of investment in Mozambique in the late 1990s are in part a result of a number of successful mega projects. The establishment of the Mozal aluminium smelter brought US$1.3 billion of foreign investment. Also, investment in the Maputo Corridor transport and related infrastructure is specifically intended to act as a catalyst for further foreign investment. Infrastructure projects may also explain most of the substantial inflows into Lesotho since 1995 (particularly the Lesotho Highlands Water project, which is a long-term joint venture between Lesotho and South Africa), although there have also been inflows as a result of privatisation and manufacturing investment. Lesotho recorded inflows in excess of 20 percent of GDP between 1995 and 1998, while in US dollar terms, annual FDI in this period was of the same order of magnitude as that flowing into Mozambique in 1998-1999.

Seychelles experienced a sustained period of significant direct investment inflows during the 1990s; the tourism sector is particularly important, while the small size of the economy tends to overstate the scale of these inflows when expressed as a percentage of GDP. Namibia appears to have *consistently* attracted direct investment in contrast to many SADC partners, with annual FDI in the range 2-4 percent of GDP between 1991 and 1998. For Swaziland, large inflows throughout the first half of the 1990s may be associated in part with production for the South African market (in the late 1980s and early 1990s, Swaziland secured several foreign investments from international companies seeking to relocate South African subsidiaries). More recently, following the start of the political transition in South Africa, there has been some fall in FDI into Swaziland, although an inflow of 10 percent of GDP was recorded in 1998.

In Zambia and Tanzania, inflows of FDI as a percentage of GDP show a step increase in the second half of the 1990s. For Tanzania, the increase has followed the implementation of broad economic reform, which has included the privatisation of state-owned enterprises. Similarly in Zambia, economic reform and privatisation have played a role in encouraging investment. In particular, the partial privatisation of the copper mining industry - the country's main export sector - has been of importance for the Zambian economy[15]. Malawi too appears to have experienced some increase in inflows at the end of the 1990s, although it is too soon to know whether this will be sustained over several years, as in Tanzania and Zambia.

Despite having fast-growing economies over the decade, FDI in Botswana and Mauritius has been low in comparison to other SADC members. Neither country has had - or needed - a large-scale privatisation programme, a major source of FDI in other African countries. Also, during the 1990s, there have been fewer mega infrastructure projects as seen elsewhere in the region. It is worth noting, however, that net FDI inflows as a percent of GDP in Botswana were considerably higher during the 1980s (an average annual net inflow of 5.3 percent between 1980 and 1984 and 3.5 percent between 1985 and 1989).

Zimbabwe has also experienced relatively low levels of direct investment in comparison with most regional partners, although some limited improvement is evident in the second half of the 1990s, especially in 1998. However, given the level of economic instability and political uncertainty currently facing the country, it seems highly unlikely that substantial new inflows of direct investment will take place in the short to medium term.

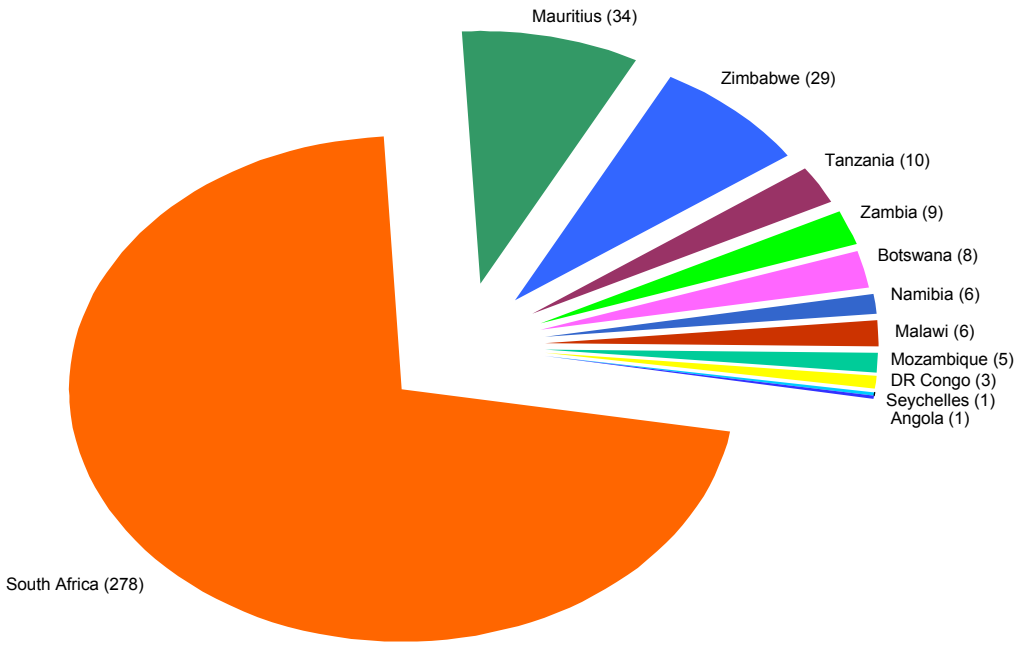
It is clear that privatisation has been one of the important sources of FDI in SADC in recent years, although this has been a difficult process for the countries concerned from both political and administrative perspectives. Within SADC, Mozambique and Zambia have had the most ambitious - and largely successful - programmes, although the small number of South African privatisations has dominated the value of total asset sales in the region. In these countries, much of the revenue generated by divestiture has come from foreign investment. Privatisation has also contributed to increased FDI inflows in Tanzania, as noted above. Nevertheless, for most countries in SADC, slow progress in the sales of the largest parastatal entities suggests that there is considerable scope for further inflows of FDI arising from privatisation.

3.4 Concentration of FDI in Southern Africa

As noted above, inflows of FDI into Southern Africa have been dominated by Angola and South Africa. While the oil and natural gas sector has been the main destination of FDI in Angola, South Africa has attracted foreign investment across a broad range of economic sectors. South Africa offers a considerably larger market than its neighbours (South African GDP represents more than 70 percent of total SADC GDP), together with a more developed business infrastructure, for

[15] However, this process has been set back by the announced withdrawal of one of the main investors in the privatised industry on the grounds of low copper prices and high operational costs (*Business Day*, 25.01.02).

Figure 3.1: Largest global enterprises: Location of principal subsidiaries/affiliates in SADC



Refers to most significant subsidiaries and affiliates around 450 of the top multinational companies; minor subsidiaries are excluded.
Companies identified from *Directory of Multinationals: The World's Largest Global Enterprises*, 6th edition, Caritas Data Ltd 2001

instance with respect to the banking system and capital markets. One issue that will be discussed below is South Africa's capacity to act as a magnet for FDI in the region, particularly as regional integration gathers pace.

The dominance of South Africa as a location for investment in SADC is illustrated by an analysis of the main subsidiaries and affiliates of the largest multinationals. The *Directory of Multinationals* (Caritas Data, 2001) provides information on around 450 of the world's largest (non-financial) companies. Amongst the information provided on each multinational is a list of principal subsidiaries and affiliated companies[16].

Of the multinationals described in the directory, 133 have identified subsidiaries/affiliates in SADC. Many of these companies have multiple interests in the region: either across countries or within one particular country. In total, 390 different subsidiary entities in SADC can be identified from this source[17]. The distribution across the region is illustrated in Figure 3.1. South Africa accounts for more than 70 percent of these entities. Mauritius is the next most important host country with 9 percent, followed by Zimbabwe with 7 percent. For other countries in the region, only a small number of *principal* subsidiaries could be identified, although this does not mean that

[16] Clearly, this source covers only a small subset of the total number of multinational companies in the world. To put this into context, UNCTAD (2001:239-242) estimates that there are 63,312 multinational parent corporations.

[17] This set of entities may include holding companies and representative offices in cases where it is not possible to distinguish major from minor subsidiary companies. This figure may therefore overstate the number of *productive* entities in the region associated with multinationals.

multinational investment in these countries is insignificant. One important point to note is that there may be many minor subsidiaries located across the region that are not included in this dataset. There are also several subsidiaries based in South Africa with a Southern Africa focus; it is plausible to assume that some regional investments may have taken place through South African offices and would therefore not necessarily be included here.

Thus, there appears to be a concentration of foreign subsidiaries in South Africa. Moreover, a crude comparison with an earlier version of the *Directory* (5th edition, Timbrell and Tweedie, eds., 1998) suggests that this concentration has increased in recent years. While the evidence from the above source is not entirely conclusive, it is nevertheless consistent with the discussion of the FDI data above. These data suggest that South Africa has largely dominated inflows of direct investment to the region in the second half of the 1990s.

3.5 Summary

The experience of SADC members in attracting long-term capital flows has been mixed. In US dollar terms, the amount of FDI received by SADC is a small fraction of total flows to low and middle income economies. However, for some countries in the region, annual inflows expressed as a percentage of GDP have at times exceeded flows to other developing economies. These inflows are often explained by a small number of large transactions, including investment in natural resource exploitation and infrastructure development, and also privatisation transactions. Privatisation has been an important source of FDI for some SADC countries but, in general, slow progress in the sales of the largest parastatal entities suggests that there is considerable scope for further inflows of foreign investment over time.

South Africa dominates foreign investment in SADC, receiving a substantial fraction of new FDI inflows into the region and hosting the greatest number of foreign subsidiaries across a broad range of economic sectors. One issue to be explored is South Africa's capacity to act as a magnet for FDI in the region, particularly in the context of growing regional economic integration.

4. Determinants and characteristics of FDI in Southern Africa: descriptive analysis

As noted in the introduction, the purpose of this study is to examine the primary motivations for investment in Southern Africa and whether the characteristics of foreign direct investment influences its developmental effects. The analysis draws on a survey conducted with (predominately) European parent companies with operations in SADC.The design of the survey instrument drew on a review of the methodology used in several existing survey-based studies (ses section 2.1.4). Of particular relevance was the survey of EU-based firms investing in Eastern Europe described in Lankes and Venables (1997)[18].

The survey aimed to explore the following issues:

- Motivations for investment in the host economy - why did the parent choose to invest?
- Principal markets supplied - does the enterprise supply the local market, regional market, markets in the rest of the world or some combination?
- Mode of entry - was the initial investment greenfield or an acquisition of existing assets in the host economy?
- Ownership structure - is the enterprise wholly owned by the parent firm or part-owned? Are partners local or foreign?
- Level of employment: local and expatriate
- Has the enterprise expanded or contracted in the past 5 years?
- Have there been changes in employment in the past 5 years?
- What are plans for the next 5 years, e.g., expansion, contraction?
- How do economic policy issues affect the enterprise: trade barriers; foreign exchange arrangements (including exchange controls); tax and investment incentives?
- What are the main sources of country risk in SADC?

The survey was conducted via face-to-face interviews with senior executives in the parent companies. A small team of interviewers, all with a background in research on Southern Africa, carried out the interviews. Survey forms were used to compile information, supported by interview notes which capture a wealth of anecdotal evidence about the factors driving decisions on investment in the region.

4.1 Key features of the sample of investment enterprises

Our sample consists of 81 enterprises. While this is small relative to the population of foreign investment enterprises in Southern Africa, the mix of projects by sector, size and age is intended to ensure that the wide range of companies operating in the region is reflected. The main features of the sample are described in Table 4.1.

A third of the sample consists of investments in South Africa; the remaining projects are located across the rest of SADC, particularly in Zimbabwe, Zambia and Tanzania. The dominance of South Africa is to be expected given that it is by far the largest economy in the region, accounting for more than 70 percent of SADC GDP.

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[18] We are grateful to Professor A Venables of the London School of Economics, who provided a copy of the questionnaire used in the survey of companies investing in Eastern Europe at an early stage in the design of this study.

Primary sector investments represent just over a fifth of the sample. These include mining, agriculture and mariculture enterprises. Secondary sector firms are the largest category (42 percent), and cover a broad range of economic activities, including industrial manufacturing, production of food and beverages and other consumer goods, construction and engineering, and automobiles. Tertiary sector investments account for a slightly smaller share (38 percent); these activities include banking and finance, publishing, information technology, and other consumer and business-oriented services.[19]

Table 4.1: Key features of the sample of investment projects

	Characteristic	Percentage of sample
Host country:	South Africa	33%
	Zimbabwe	17%
	Zambia	12%
	Tanzania	10%
	Other SADC	30%
Sector:	Primary	21%
	Secondary	42%
	Tertiary	38%
Size:	Small (less than 20 employees)	26%
	Medium (20 to 199 employees)	20%
	Large (200 to 999 employees)	28%
	Extra large (1,000 or more employees)	26%
Age:	Infant enterprises (5 years or less)	44%
	6-39 years	35%
	40 years or more	21%

Note: 1. The country distribution does not add to 100 because one project is categorised as cross-border and counts towards three country totals.

If the size of the enterprise is classified according to the number of employees, there is a roughly even distribution of firms across the sample. Small enterprises (up to 20 staff) represent 26 percent; the medium-sized category (20-199) accounts for 20 percent; large (200-999) and extra-large (more than 1,000) enterprises are roughly equivalent, at 28 and 26 percent of the sample respectively. Note that within these categories there can be substantial variation in firm size, in particular in the extra-large category, employment ranges from 1,250 to more than 9,000.

[19] A more disaggregated sectoral distribution of investments will not be analysed in detail in this paper. This is because a finer classification of firms would make it possible, in some cases, to identify a specific firm or group of firms from the survey evidence, violating the commitment made to preserve confidentiality of firm-level information.

Just under half the sample can be described as 'infant enterprises', in existence for five years or less. In contrast, just over one-fifth of the Southern African subsidiaries of firms interviewed have been in existence for 40 years or more (in many cases pre-dating independence from the colonial power). However, a significant number of these firms have substantially different operations from those which they began. For instance, some have become more export-oriented, others have changed sector, some have diversified, while yet others have specialised. Moreover, many of the firms that have a long history in the region have been key sources of *additional* investment in the region over time, through expanding subsidiaries or creating new companies.

The distinction between new and old enterprises is particularly stark for South Africa. Just over half of the South African subsidiaries of firms interviewed represent investments that have taken place during or since the political transition in 1994. Of the remaining investments, most have been in existence for forty or more years. This reflects the low level of direct investment that followed campaigns for economic sanctions - and the accompanying uncertainty - in the 1970s and 1980s.

4.2 Motivations for investment

Table 4.2 shows the five most important motivations identified by interviewees for location in Southern Africa. There is a considerably longer list of reasons why individual firms make decisions to locate a subsidiary abroad, but these become increasingly case-specific as the proportion of firms identifying them diminishes.

Table 4.2: Motivation for location within Southern Africa, percentage of sample

	All sample
Local market size	68
Availability of natural resources/raw materials	32
Historical/personal links with Africa	21
Strategic reasons	17
Privatisation/public-private partnerships	15

Note: Shares sum to more than 100 because interviewees frequently identified more than one reason.

Local market size

More than two-thirds (68 percent) of the sample indicated that the size of the local market was one of the main reasons for locating in the host economy. Almost all of the non-primary sector firms chose initially to invest in the region in order to supply local or regional markets; rather than to establish a base from which to export to the rest of the world. Markets supplied are explored in more detail below.

It is important to bear in mind that all firms interviewed actually have investments in Southern Africa. One of the constraints to foreign investment in SADC highlighted by Hess (2000) was the small size of most of the domestic markets in the region. He argues that most countries have small populations with relatively small purchasing power and that many economies are reliant on one or two sectors, which means populations are vulnerable to swings in income. For this reason, Hess

urges a speedy implementation of the SADC trade protocol in order to create a larger regional market. The survey findings support Hess's arguments. First, because the size of the local market is frequently one of the main reasons to invest, where domestic markets are small, only a limited number of foreign investors are likely to enter. Second, it is shown below that regional markets are important for many of the (non-primary sector) firms in the sample. This is particularly the case for those investments in the smaller economies of the region. A functioning free trade area is more likely to offer the economies of scale required for investment to be profitable and thus should encourage more direct investment in the region.

Other features

In addition to the size of the local market, the survey revealed a range of motivations for investing in particular countries within Southern Africa. Most of these reasons are specific to the type of activity undertaken and so no clear pattern emerges on motivations for investment, other than the objective of entering local markets.

For instance, for primary sector producers, almost all investments are driven primarily by the presence of natural resources. The availability of raw materials was also identified as a factor in the location decision for around a third of the secondary sector firms encompassing a range of manufacturing activities. Just under one fifth of the sample are service sector multinationals, many of which state that they have a presence in the region less to serve the local market as to serve global corporate clients with either a trade or investment presence in the region. Their motivation for investment can therefore be described as strategic. Privatisation programmes and/or opportunities for public-private partnerships were a motivating factor in 15 percent of the investment projects.

One interesting - but region-specific - explanation for why some of these firms maintain subsidiaries in Southern Africa is historical links. In around one-fifth of the subsidiaries, the interviewee acknowledged that investment in the region is associated with an historical or personal link to Africa. For instance, the firm may have had a presence in Africa for around a century, and current decision-makers are influenced by these ties. In small firms, personal ties also exist, often where decision-makers have lived in Southern Africa for many years.

Historical links are one reason why a firm would not necessarily disinvest during extended periods of severe macroeconomic instability or deteriorating market conditions for the particular product. There are sunk costs associated with establishing and growing a subsidiary over time and production may continue because it remains profitable, even if profits are markedly lower than in previous decades.

For some of the firms interviewed as part of this survey, historical and/or personal links with parts of Africa mean that they view themselves as "Africa specialists", as well as product specialists. Indeed, interview evidence reveals that a long investment in local knowledge (meaning a presence in the region for almost a century) can mean that the focus of regional operations changes over time - either in terms of sector or country - as more profitable opportunities for investment are identified.

These findings have relevance for attracting FDI into Southern Africa. Firms that have a presence in the region are important potential sources of additional investment, either through expanding the number of operations in the region or through reinvesting in existing subsidiaries. Information costs are likely to be lower for firms with a long presence as they are able to draw on the

experience of operating in the region in making new investment decisions. Moreover, as discussed below, existing firms are less likely to be influenced by the narrow view that economic and political instability is endemic across Africa. By contrast, firms without a long history in Africa might be more hesitant to commit irreversible capital expenditures in a continent frequently depicted as poor and unstable.

4.3 Destination of output: local, regional and world markets

The majority of these subsidiaries have a focus on producing for the local market. Four fifths of the firms interviewed supply the local market; less than a third export outside of Southern Africa (Table 4.3). Of the firms which produce for the local market, just under half *also* produce for the regional market, and only 14 percent supply markets abroad.

Table 4.3: Destination of output: local, regional and world markets, percentage of sample

	All sample	Local market suppliers
Local market	80	100
Regional market	36	45
Rest of world	31	14

Note: In the all-sample column, shares sum to more than 100 percent, because firms supply a combination of markets. This is reflected in the next column which shows, of the firms supplying local markets, the percentage which also supply regional and/or rest of world markets.

Local and regional markets

Of the enterprises producing for the local market in the host economy, just under half (45 percent) also supply the regional market from the local base. Indeed, firms often perceive the *local* market to be the entire Southern African region, or, in some cases, even the African continent. Access to the regional market is especially important in cases where domestic markets are too small to justify several direct investments. As mentioned above, the implication is that regional integration initiatives - to the extent that they support a larger regional market - are likely to be important in terms of encouraging investment.

More than half of the sample of enterprises supplying both the local and regional markets are located in South Africa. Generally, these firms are primarily concerned with the South African market, often viewing sales to the region as a relatively minor component of operations. This is not surprising given the difference in market size of these economies. One implication is that South Africa can be seen to act as a natural base for expanding into the region. In other words, South Africa is often seen as pivotal to regional production and trade. Many of the South African-based operations in the sample began by supplying the local market and over time expanded to supply regional (and world) markets. In section 2 it was noted that South Africa tends to attract much of the FDI in Southern Africa and the interview evidence suggests that this is likely to continue. There is, therefore, a risk that South Africa will attract much of the gain in terms of increased foreign investment arising from regional integration. This issue is explored further below.

Competition in local markets

Of the firms producing for the local market, the most important source of competition is from other local firms (domestic and foreign-owned), more so than competition from imports: 75 percent of this subset of enterprises face local competition; 40 percent face competition from imported goods (note that some firms face competition from both sources). Foreign-owned domestic firms play a particularly important role as competitors[20].

Information on the share of the local market captured by these firms is rather weak, but some tentative conclusions can be drawn. Where firms were able to report market share, the largest fraction (44 percent) were in a range of 10 percent to 30 percent. There are marked variations in the ability of these firms to compete for market share: firm size is one obvious factor; another is that some heavy industrial sectors are characterised by a small number of large firms, because investment can only profitable when economies of scale are realised. In the case of investments located in South Africa, very few enterprises claim to have a market share of more than 30 percent: 55 percent have a market share of between 10 and 30 percent, while 36 report a share of less than 10 percent. This is consistent with anecdotal evidence from interviews that South Africa is characterised by greater levels of competition than the rest of the region[21].

World markets

As noted above, less than a third of the Southern African subsidiaries of firms interviewed (31 percent) export to world markets. Most of these are primary sector firms, especially in mining, where a global rather than local focus is expected.

The relatively small number of non-primary sector enterprises producing for the world market, are located in South Africa. These enterprises also produce for the South African market, and most sell into Southern Africa too. The pattern that has emerged from interviews is that these firms initially invested in South Africa to supply the local market. Over time, there was a re-orientation towards production for export, in particular during the post-political transition era. This period (since 1994) has also been associated with a vigorous programme of trade liberalisation, which has helped to raise the competitiveness of South African industry. In the sample, there are a small number of examples of where the relocation of production for global markets to South Africa from other countries has taken place. There is thus some evidence from the survey to suggest that South Africa can compete to attract global manufacturing, but this is a relatively recent phenomenon and does not yet appear to have taken place on an extensive scale. The local market remains an important focus for the firms concerned.

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[20] Foreign-owned local firms can also act as a source of demand and a source of inputs, although these were not found to be particularly important features of the local economy for the majority of the enterprises in our sample.

[21] This does not imply that all sectors in South Africa can be characterised as having adequate levels of competition. Even though South African industry is often considered uncompetitive, the service sector is considerably more buoyant, and certainly more so than in many other African economies.

Changes in the destination of output

In only a small number of cases has the destination of output changed significantly in the past five years. Only 6 percent of the sample of enterprises reported that the markets served (local, regional and world) had increased (Table 4.4). These enterprises are all based in South Africa where an increase in exports outside of Africa has taken place. A slightly higher number, 8 percent, expect to expand into regional and world markets in the next five years; again these are all located in South Africa.

Table 4.4: Changes in the destination of output: all markets, percentage of sample

	Past five years	Plans for next five years
Change[1]	6	8
No significant change	94	92

Note: 1. In this limited number of cases, enterprises have expanded or are planning to expand the share of output exported to the region or to the rest of the world.

The conclusion that may be drawn is that existing markets, particularly local markets, remain the main focus of activities for most of the enterprises in our sample[22]. However, it is worth noting that outward orientation does appear to be taking place in a number of South African enterprises in the sample. If we consider the subset of South African investments, around one-quarter are plannng to expand exports in the next five years. This is one important distinction in the sample between enterprises based South Africa and those based in the rest of the region.

4.4 Recent and planned changes in Southern African operations

Almost half of the sample reported some form of expansion in the enterprise over the last five years (Table 4.5). Expansion is defined as additional investment to increase and/or modernise production capacity or to diversify operations. In the subset of subsidiaries located in South Africa, the most significant expansions have been undertaken with a view to increasing capacity to export to the rest of the world.

Table 4.5: Recent and planned changes in enterprises, percentage of sample

	Past five years	Plans for next five years
Expansion	49	54
Contraction	8	10
New project	13	0
No significant change	29	31

[22] This does not necessarily mean that there is an absence of export-oriented investment in the region. For instance, Lesotho has reportedly attracted investment in the textiles sector from East Asian companies seeking to export to the US (John Thoburn, TIPS Workshop, Johannesburg, June 2002).

Less than one tenth of the sample reported contraction over the last five years. Downsizing is almost always associated with rationalisation and restructuring, although some disinvestment for commercial reasons also has taken place[23].

Plans for the next five years show signs of investor confidence. Across the whole sample, more than half (54 percent) of the parent companies are expecting to expand projects in the next five years. A substantial proportion of planned expansions are for enterprises located in South Africa and in tertiary sector activities. Only 10 percent of the sample of enterprises are expected to contract in the next five years. Reasons for this vary and are often country-specific: poor performance of the particular sector; increased uncertainty in the political and economic environment (in the case of Zimbabwean enterprises); strategic withdrawal from one sector (and expansion in another); and dissatisfaction with the business environment.

Employment

In contrast to the positive picture painted by expansion of these enterprises over the past five years, only 27 percent of the enterprises reported that employment had increased in the same period; 35 percent reported that employment had decreased, with the remainder reporting insignificant changes in employment (Table 4.6).

Table 4.6 Changes in employment in the past five years, percentage of total sample

	All sample
Increased employment	27
Decreased employment	35
No significant change	37
Expatriates wholly or partly replaced by local labour	33
Memo item: % employing expatriates in past 5 years	*68*

Of the firms which have *expanded* their operations in the past few years, less than half (46 percent) reported an associated increase in the number of employees in the enterprise concerned[24] (Table 4.7). However, one-quarter achieved expansion while simultaneously reducing the size of the workforce; a similar proportion achieved growth without any significant change in the level of employment.

[23] A small number of enterprises (less than 10 percent) have undergone some change in the type of core activity undertaken. This has included moving from a sales base to a production base and vice versa, and the integration of the subsidiary in the global supply chain of the parent. In only 4 percent of the sample is the parent planning a significant change in activities in the next five years.

[24] Note that, in some cases, expansion has taken the form of diversification through the parent's acquisition of local companies. These acquired operations are not necessarily integrated into the investment project which is the focus of the survey. In this case, the survey would not necessarily record an increase in employment even though the number of people now employed by the parent has increased.

Table 4.7 Changes in employment in the past five years, percentage of *expanding* firms

	Percentage of expanding firms
Increased employment	46
Decreased employment	25
No significant change	28

One reason for this is that expansion can be undertaken without necessarily increasing employment, through a combination of improved technology and productivity. Interview evidence suggests that this has been the case for a significant proportion of the expansions which have taken place in South Africa. Just over half of the expanding largest enterprises in South Africa have experienced stable or declining employment levels, either as a result of rationalisation or because of improved technology and/or productivity gains.

This finding is generally consistent with studies on employment in South Africa which focus on the impact of increased trade openness on the labour market. Jenkins (2002) finds that net trade has had a small positive effect on non-agricultural employment, although this effect is biased towards more skilled labour. He also finds that the major factor contributing to reduced levels of employment in the 1990s is increased productivity (see also Edwards, 2001). He further identifies a link between reduced labour utilisation and increased import penetration in manufacturing in the 1990s, arguing that once the negative effect of rationalisation in response to international competiton is taken into account, then the overall trade impact on manufacturing employment is likely to be negative.

Finally, more than two-thirds of the enterprises in the sample employ expatriate labour, although in the majority of cases the fraction of the workforce accounted for by expatriate labour is very small. In almost half of these enterprises, expatriates have been replaced by local labour (either wholly or in part) in the past five years (Table 4.6). One reason why firms prefer local labour, assuming that the necessary skills are available, is that the cost of expatriate labour is comparatively high. Many parent companies have an explicit policy of localisation, some viewing this as part of their commitment to the country concerned, and others pre-empting overt pressure to engage in indigenisation.

Sector, growth and employment

Half of the *expanding* enterprises in the sample are tertiary sector firms (51 percent); one third (32 percent) are in manufacturing; the remainder are in the primary sector. It is evident that tertiary (service) sector firms tend to be smaller in terms of the number of employees than either primary sector or manufacturing subsidiaries.[25] This is demonstrated in Table 4.8

Of all the service sector firms in the sample, almost two thirds extended their scale of operations in the past five years, and a full two thirds are planning for further expansion in the next five years. The proportion of these firms which also increased employment is significant, but very much smaller - closer to one third. Because these firms are comparatively small in terms of overall employment, the impacts on welfare of growth in these firms would tend to be small. However,

[25] The largest firms in the tertiary sector were in banking and finance.

one contribution to welfare, via skills transfer, is evident: although approximately half of service sector subsidiaries employed expatriate staff in the five years prior to the survey, around three quarters of these were actively engaged in localisation. The result is likely to be a transfer of skills, an important benefit of FDI.

Of the sample of secondary sector firms, 35 percent enlarged their scale of production in the past five years, with just over 40 percent planning to grow in the next five. But nearly half of firms in this sector reduced employment in the five years preceding the interviews. The creation of jobs in manufacturing is an important objective of general economic development, and that output growth is occurring without employment expansion in a significant fraction of these foreign-owned enterprises is disappointing, especially if it is an indication of what is happening in domestically owned firms as well. As noted above, enterprise enlargement is often achieved by raising the capital intensity of production and/or improving labour productivity, and the interview evidence suggests that this has been important in the manufacturing sector. A small number of manufacturing enterprises in the sample (just over 10 percent) downsized in the late 1990s, with negative implications for welfare.

Localisation of the workforce in manufacturing appears to have been slow: of the 80 percent of secondary sector subsidiaries employing expatriates, only two fifths replaced foreign workers with locals in the past five years. There have therefore been proportionally fewer opportunities for the transfer of management skills than in the service sector.

In primary sector activities, many of which are large employers, employment tended to increase or remain the same over the period. Further economic benefits of this form of FDI are likely to have come from the capital and technology necessary to exploit natural resources on a large scale, together with the foreign exchange earnings that this sector tends to deliver.

Table 4.8: **Growth and employment of firms by economic sector**, **percent of the full sample**

	Primary (21% of sample)	**Secondary** (42% of sample)	**Tertiary** (38% of sample)
Small & medium	189	27	82
Large & very large	81	73	17
Expansion in last 5 years	50	35	63
Planned growth in next 5 years	59	41	67
Employment up	46	13	36
Employment down	18	48	24
Expatriates employed	57	81	52
of which replaced	*25*	*41*	*73*

Welfare implications

Given the importance of employment creation in reducing poverty, we conclude that the direct welfare effects of the sample of enterprises reported here are limited but not insignificant[26]. Firms which are expanding are largely, though not exclusively, service sector firms with generally lower rates of employment, which tends to be more skilled. A significant proportion of manufacturing enterprises have expanded productive capacity while reducing employment, although this is by no means universal. It should be noted that the diffusion of technology is itself a potential benefit of FDI, and indirect evidence that some enterprise expansion, especially in manufacturing, is achieved by rising capital intensity, suggests that an upgrading of technology has taken place.

Whatever the sector, enterprise expansion does not always translate directly into more employment opportunities, although there may be indirect job creation, which this survey is not expected to capture.

One of the primary forms in which diffusion of management skills occurs is through the localisation of management positions within subsidiary companies. The reasonably rapid rate of localisation of management positions reported by firms interviewed for this project suggests that historical weakness in this area might now be changing. Explicit or implicit localisation policies pursued by several African governments could be accelerating the rate of replacement of expatriate staff. This trend has undoubtedly been reinforced by the fact that exchange-rate depreciation is making expatriates increasingly expensive relative to local personnel, and that perceptions of high crime levels in South Africa are a disincentive for attracting potential expatriate staff.

4.6 Method of entry and ownership structures

Method of entry into the host economy

The form in which FDI occurs may influence the extent to which the host country benefits from the presence of foreign-owned firms. It is sometimes argued in the literature that movement towards acquisitions as the primary method of entry by multinational enterprises not only generates fewer new jobs but might also destroy existing employment through restructuring and rationalisation. Other concerns include the possibility of market dominance of strategic sectors by new foreign owners; and the possibility of reduced competition as domestic firms are eliminated. The *World Investment Report 2000* (UNCTAD, 2000) notes that mergers and acquisitions dominate direct investment inflows into the developed countries and are also now observed as a method of entry for foreign companies into developing economies.

Of the total sample of projects covered in the survey, half of the original investments can be described as a pure greenfield investment, 37 percent of projects were acquisitions, while 10 percent are described as some combination of greenfield and acquisition (Table 4.9). It would appear therefore that greenfield investment has been the more common method of entry into Southern Africa.

[26] Our relatively small sample of firms accounts directly for around 100,000 jobs in Southern Africa.

Table 4.9 Method of entry into host economy, percentage of sample

	All sample	Infant enterprises
Greenfield investment	50	44
Acquisition	37	50
Greenfield and acquisition	10	6

Note: The "all sample" category does not sum to 100 because it includes sales bases which are not described as greenfield investments or acquisitions.

However, many of these investment enterprises have been established for a long period, whereas the global trend towards mergers and acquisitions is a relatively recent feature of direct investment. In order to consider whether acquisitions have become more common in SADC, we look at the subset of infant enterprises, defined as enterprises in existence for five years or less. Of these enterprises, exactly half represent investment by acquisition; 44 percent are greenfield investments, 6 percent are a combination. There is thus some evidence to suggest that investment by acquisition has become more common in SADC in recent years, although it cannot be concluded that this method of entry is necessarily preferred to greenfield investment.

One reason why acquisitions have become more common is that privatisation programmes in the region have provided opportunities for the acquisition of state-owned assets. Another reason is that South Africa's developed corporate sector offers potentially greater prospects for acquisitions than other regional countries, particularly in the post-apartheid era. Across all the South African enterprises in the sample (old and new), there is a clear bias towards greenfield investment as the preferred method of entry; but in the subset of investments taking place in South Africa in the last five years, acquisitions and greenfield investments are equally balanced.

The conclusion to be drawn is that, while acquisitions have become marginally more common in SADC, greenfield investment has continued to play an important role. The weak competitive environment in some sectors may give rise to concerns about the increasing number of acquisitions (at least outside of South Africa). The acquisition of domestic companies by multinationals may hinder the development of the local (indigenous) corporate sector to the extent that competition is reduced. This effect is weakened by an apparent tendency of acquisitions to involve local partners. In our sample of projects, greenfield investments are more likely to be wholly-owned than part-owned. The reverse is true for acquisitions - although the difference is not substantial: 52 percent of the acquisitions are part-owned - and it appears that most of these enterprises are owned with local partners (as opposed to other foreign firms).

Ownership structures

The choice of ownership structure tends to reflect the preference of parent companies to retain control of their foreign subsidiaries. In the sample, there is an exact balance between enterprises which are wholly owned by the parent company and those that are part owned (Table 4.10). Of the part-owned enterprises, around three-quarters are majority owned, and partnerships are generally with local firms or individuals.

Table 4.10: Ownership structures, percentage of sample

	All sample
Wholly-owned	50
Part-owned	50
Majority	*38*
Minority	*12*

Interviewees revealed that, for wholly-owned enterprises, the choice of ownership structure is explained by corporate preferences rather than by factors specific to the host economy. In other words, parent companies prefer full ownership (or at least majority control) irrespective of where international investments are located. One reason is that full ownership is seen as necessary for ensuring the integrity of the company brand and/or reputation. Another reason is that full ownership is often considered important for management purposes where subsidiaries form part of a global supply chain or production process. The latter reason would, of course, be less relevant where subsidiaries are producing for local markets only.

In part-owned enterprises, foreign firms seek out local partners for a variety of reasons. In some Southern African countries, government regulations and/or procurement policies requiring a degree of local ownership do play a role in encouraging foreign firms to sell a proportion of the equity to domestic investors. However, there are also *commercial* reasons for seeking local partners. Among the non-regulatory reasons for establishing joint ventures is the value of local knowledge of domestic markets and the perceived importance of a local identity in terms of creating a competitive edge. This suggests that local partners are more relevant for enterprises competing in local markets, although the larger multinationals are more likely to rely on superior marketing power[27]. A small number of investors expressed the opinion that partnerships are important from a developmental perspective, although these were typically investors with a long, and sometimes personal, history in Africa. Moreover, some companies view the involvement of local equity partners as a means of mitigating risk, although this is only one factor among many used in managing risk.

One issue to emerge from the survey is whether government regulations are an appropriate means of encouraging foreign investment in the form of joint ventures with local partners. The use of procurement policies and requirements on ownership can act as a deterrent to investment by those multinational corporations that wish to retain full control of their subsidiaries, regardless of where they are located. This does not mean that firms with a preference for full ownership will not invest: in the sample there are examples of firms which have local partners for regulatory reasons but which would otherwise prefer full ownership. In these cases, management control is seen to be the most important factor. Nevertheless, if an investor is deciding between two investment locations, the presence of restrictions on ownership in one location will undoubtedly affect its relative attractiveness as an investment destination.

[27] More than 80 percent of the sub-set of extra-large enterprises producing for the local market are wholly foreign owned.

Welfare implications

As noted above, the literature suggests that changes in ownership generally may have an adverse impact on both employment and production. Clearly most greenfield investment adds to a country's productive capacity[28] and creates new jobs. Once an enterprise is established, however, our survey findings reveal no unambiguous evidence that the initial mode of entry makes a significant difference to the employment-creating ability of a firm.

We find in our sample that firms acquired by purchase do not necessarily undergo major restructuring in the early years after acquisition. In the subset of infant enterprises (i.e., investments that have taken place in the last five years), reductions in employment are only marginally more common in the case of recent acquisitions than in the case of new greenfield investments (36 percent of acquisitions versus 31 percent of greenfield investments). Although there are a number of cases of post-acquisition restructuring in our sample, stable or increasing employment has occurred in the majority of the recent acquisitions. But an important caveat here is that the small size of the divided sample means that this finding is suggestive rather than conclusive.

The literature argues that joint ownership of equity with local partners leads to a diffusion of human capital as well as a sharing of profits. This is an important benefit, especially if there is a growing concern that local ownership should include partners from disadvantaged backgrounds. Joint ventures are found to be more common in the case of acquisitions than greenfield investment. This should mitigate to some extent the adverse impact on the development of the domestic corporate sector that can occur if foreign firms engage in oligopolistic behaviour. This tells us nothing, however, about the distribution of ownership opportunities within the host economy and whether joint ownership actually exacerbates inequality through being concentrated in a only small section of the local population. Finally, we also find that rapid localisation of employees has been less common in our sample of acquired enterprises (relative to greenfield investments), undermining the potential transfer of management skills.

4.7 Economic policy issues

The survey also explored how policy-related variables impact on multinational subsidiaries.

Exchange rates and the availability of foreign exchange

Exchange rates and/or access to foreign exchange emerge as important issues for just over half of the sample of enterprises. The *instability* of exchange rates is found to have an adverse impact on 36 percent of enterprises in the sample (Table 4.11). Rapid depreciation of local currencies erodes the foreign currency value of both profits and equity, and can create the perception that the profitability of operations is static or declining because foreign investors are necessarily concerned with hard currency profitability in the long term. This applies particularly to firms producing for the local and regional market. Where output is sold in world markets, with earnings denominated in foreign currency, profitability is less exposed to fluctuations in the value of the local exchange rate. Furthermore, exchange controls and the availability of foreign exchange were identified as a barrier to investment by 25 percent of the sample. Uncertainty over the ability to repatriate profits - either in the presence of formal exchange controls or where foreign exchange shortages persist - can create a significant additional risk for investors in the region. Lack of

[28] The most common exception is the opening of a distributive outlet to market products manufactured abroad.

access to foreign exchange is also a problem for those enterprises with a high level of imported inputs.

Table 4.11: Adverse impact of foreign exchange arrangements, percentage of sample

	All sample
Exchange controls or availability of foreign exchange	25
Instability of exchange rates	36
No significant impact	47

Note: Sums to more than 100 because a some interviewees cited exchange rate instability *and* availability of foreign exchange.

The combination of uncertainty created by a depreciating currency and lack of access to foreign exchange is found to be particularly acute for those enterprises operating in Zimbabwe at the time of the survey. Most firms operating in Zimbabwe reported severe difficulties in acquiring foreign exchange, either for importing inputs for production or for repatriating earnings. However, foreign exchange uncertainty is not confined to countries experiencing extreme economic instability. For instance, foreign exchange issues in South Africa are found to be a concern for almost half of the South African enterprises in our sample, despite a generally favourable view of the macroeconomic policy framework in the country.

Taxation and investment incentives in the host economy

One of the five significant barriers to foreign direct investment identified in Hess (2000) is high taxation. Hess notes that, by world standards, tax rates are particularly high in several SADC economies. He further argues that while incentive schemes have been developed in order to reduce the burden of taxation, these have often been complex to administer and lacking in transparency.

The survey offers partial corroboration for Hess's findings. Few investors interviewed (only 17 percent) expressed the view that the existing tax regime in the host economy has a positive influence on their investment decisions, either in the form of explicit incentives or otherwise relatively low tax rates. Most view the issue of taxation (tax rates and/or tax complexity) in Southern Africa negatively.

In line with findings from elsewhere (see for instance UNCTAD, 1998), investment incentives were found to have only a minor influence on investments by firms interviewed. Almost 70 percent of the sample indicated that incentives for FDI were not relevant; the remaining firms reported that they have either benefited from a general incentive scheme in the host economy or received specific incentives for the project concerned. In only a small fraction of cases (less than 5 percent) have incentives been an important aspect of the decision to invest. This supports the view that incentives are, at best, a secondary factor in attracting investment to a particular location.

Trade barriers

Formal trade barriers to importing inputs and exporting outputs do not appear to have a significant impact on the majority of the investments in the sample. Only 14 percent of enterprises reported difficulties with barriers to selling output; trade barriers to imported inputs are problematic for only 7 percent.

Because the local market is the focus for output for the majority of firms, trade barriers in overseas markets are generally not relevant, although some of the non-mineral sector exporting firms did cite EU trade barriers as problematic. Regional trade barriers are more likely to be relevant for firms desiring to serve all SADC countries from one (or a few) operations. However few of these firms cited tariff barriers to intra-regional trade as a severe constraint on their operations. Of greater significance in intra-regional trade are non-tariff barriers, particularly non-standardised bureaucratic procedures and transport links which are effectively broken at international borders. The free trade area established by SADC members will thus need to address a broad range of constraints to trade if it is to be effectual in creating a regional market of sufficient size to attract investors whose profitability is dependent on exploiting significant economies of scale.

4.8 Sources of country risk

Interview evidence suggests that perceptions of country risk tend to vary according to the firm's individual experience of operating in particular countries. The survey respondents were asked to identify sources of risk faced in the countries in which they have investments from a list of factors[29]. The results are summarised in Figure 4.1. This chart illustrates the percentage of respondents identifying particular risk factors associated with the host economy. Note that this should *not* be interpreted as meaning that all countries in SADC are characterised by similar risks, as discussed below.

Economic stability and governance

The two most common risk factors to emerge from our survey are unstable macroeconomic environments, frequently characterised by instability of exchange rates, and regulatory uncertainty. Foreign exchange arrangements are discussed in an earlier section. Concerns about the quality of governance cover a wide range of issues. These include the risk of intervention in property rights, the unpredictability of bureaucratic requirements - for example institutional weaknesses may mean that securing work permits and other licenses can be a lengthy process - and the uncertainty about the effective functioning of the business environment in the presence of corruption[30]. Political uncertainty is also perceived as a risk for investors in some of the countries in the region. Unstable political environments increase the uncertainty faced about the future direction of economic policy and the regulation of private enterprise.

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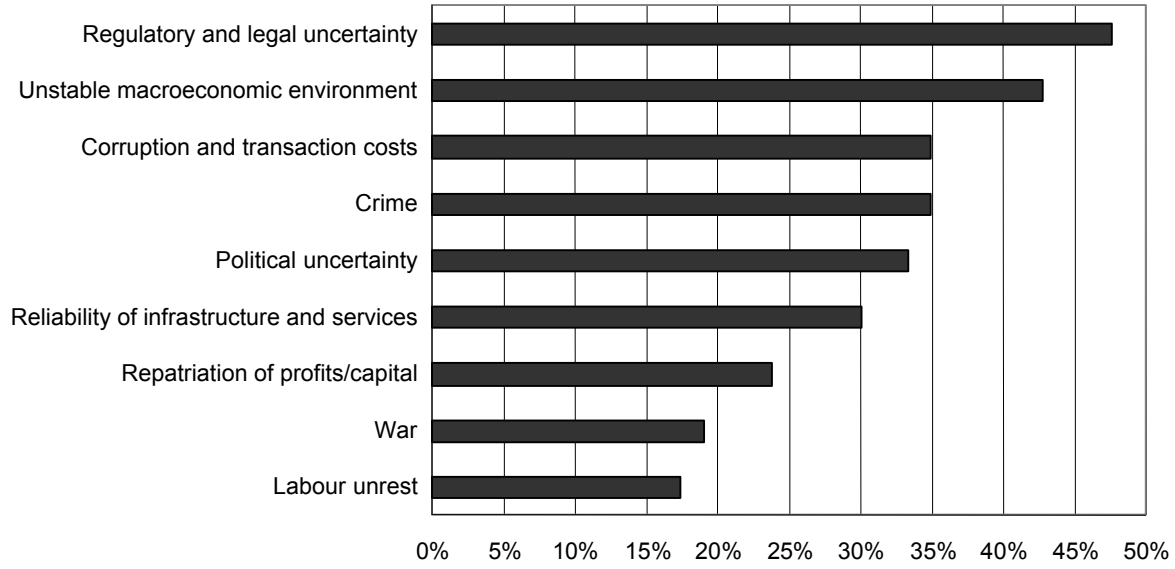
[29] The sources of risk included on the survey form covered: macroeconomic instability; repatriation of profits/capital; regulatory and legal uncertainty; crime, corruption; political uncertainty; war; labour unrest; and unreliable infrastructure and services.

[30] Several interviewees emphasised that this does *not* necessarily mean that firms engage with corruption.

Figure 4.1: Sources of risk in SADC



Measures the percentage of respondents identifying a particular risk factor associated with a SADC country in which they invest. Countries in SADC are not necessarily characterised by identical risks

Differences in risks across the region

Existing investors tend to be informed about the risks faced in particular countries: the interviewees in this survey frequently drew distinctions between investment climates and economic stability in different countries of the region, and perceptions of risk tended to vary from country to country. Botswana is viewed as relatively stable, although the impact of HIV/AIDS is an area for concern. In South Africa, the survey suggests that most severe risk is the high crime rate: investors often point to crime as one reason for the emigration of skilled labour and capital flight. This finding is in contrast to South Africa's regional partners, where crime is seen as much less of an issue. In Angola, war and political uncertainty dominate perceptions of risk. The reliability of infrastructure emerges as a significant risk in Tanzania. In Zambia, governance issues were most often identified as risk factors. In Zimbabwe, macroeconomic instability and regulatory and political uncertainty are the key sources of risk, although these views were driven by the climate of general instability in the country at the time of the survey. Many of the investors interviewed for this survey see the investment climate improving in the countries in which they operate, although this is not universally the case, either within countries or across countries.

In addition to the factors set out on the survey form, some investors identified the impact of HIV/AIDS as a risk faced in investing in the region. Apart from the human cost of AIDS, there are concerns from an operational perspective: the cost implications of disruptions to the workforce and the need to recruit in the context of high mortality rates; and concerns about the long-term impact on economic growth.

Existing versus potential investors: The "Africa perception"

Our interview evidence supports the view that *existing* investors tend to be more informed than *potential* investors about differences in the economic and political climates that exist across Southern Africa. In the absence of information based on the experience of operating in the region, potential investors not yet present in Southern Africa are more likely to be influenced by the frequent portrayal of economic and political instability as endemic across Africa. Many interviewees in our survey pointed to the "Africa perception" as a significant barrier to FDI in the region.

For the larger firms in the sample, benchmarks for the rate of return on investing in Africa were generally reported to be higher than those for investments in other parts of the world. Figures provided on benchmarks appear to vary across sectors and it is worth noting that interviewees frequently argued that the assessment of projects takes into account a variety of factors, not just the return on equity. Nevertheless, the required risk premia identified in the survey may be consistent with evidence from other studies that returns on FDI in Africa are higher than elsewhere. For example, Asiedu (2002) reports UNCTAD figures comparing rates of return on US direct investment in Africa with those achieved in other regions: the 1991-1996 average annual rates of return were 29.8 percent in Africa, compared to 16.3 percent for all developing countries, and 11.8 percent for all countries. Our survey evidence suggests that for new investment projects in Africa to be approved in the boardroom, parent firms may require the expected rate of return to be relatively high to compensate for the *perceived* riskiness of the investment environment. If the "Africa perception" is translated into an "Africa premium" in benchmark rates of return for investment projects, then this could be one contributing factor in the findings from other studies that *observed* returns are higher in Africa.

The Zimbabwe factor and Africa perceptions

During the period in which the survey was conducted, Zimbabwe was characterised by severe economic instability and political uncertainty. Anecdotal evidence suggested that this local instability has had a negative impact on perceptions of stability in the region as a whole. Our survey requested information on the extent to which investors fear that spillover of instability into the region could occur and also information on expectations of the long-term impact of current economic and political instability on the Zimbabwean economy.

Impact on the Zimbabwean economy

Of the firms that have investments in Zimbabwe, almost four-fifths reported that current instability has direct adverse consequences for operations. Profitability is poor and many of these enterprises are being subsidised by the parent at present. One of the most significant operational difficulties is the lack of access to foreign exchange, either to import inputs for production or to repatriate earnings. Moreover, in periods of rapid depreciation, the foreign currency value of earnings has been eroded between the time earnings are generated and the time they are repatriated.

Despite these difficulties and wider criticisms of the political and economic environment in the country, only a small number of firms in the sample are considering withdrawal in the short-term; instead, a more common approach seems to be "wait and see". This is particularly so for those firms with a long history in Zimbabwe. Almost half of those interviewees with operations in Zimbabwe expressed long term optimism about the future of the country but a common view was that significant reforms must first take place.

Regional spillover

Few investors expect the economic and political crisis in Zimbabwe to have a direct spillover effect in the region. Less than one-fifth of survey respondents expressed the opinion that there was some risk of a spillover of events in Zimbabwe to the neighbouring countries. However, of greater concern is that the crisis in Zimbabwe has had an adverse impact on general perceptions of stability in the region.

One reason why outside perceptions matter to firms is that raising finance for investment may become more difficult or costly where foreign bankers and institutional investors perceive the region to be unstable. Events in Zimbabwe may also make it more difficult to win support for new investment projects in Africa at the most senior level of management in large multinational companies. Perceptions of instability can be damaging to the prospects for increased flows of investment into the rest of the region, which are seen as necessary for increasing rates of economic growth. Recent events in Zimbabwe have served to exacerbate the perception of instability in Africa with the implication that countries in the region may find it more difficult to compete with other investment destinations in the developing world.

4.9 Summary of the findings

The descriptive analysis of the sample of enterprises suggests the following conclusions:

The most important motivation for investment is the size of the local market. Most of the non-primary sector enterprises have a local market focus, and few firms in the sample are seeking to develop export capacity to markets outside of Southern Africa in the medium term (the exceptions are all located in South Africa). Economic growth to increase the size of the local market may need to be a precursor to higher levels of FDI. Where domestic markets remain small, only a limited number of foreign investors are likely to enter. A functioning and sustainable free trade

area is more likely to offer the economies of scale required for investment to be profitable and thus should encourage more direct investment in the region. South Africa is seen by many investors to be pivotal for regional production and trade.

Other important motivations for investment include the presence of natural resources (this applies to primary sector firms and one third of manufacturing firms in the sample); historical links with Africa; privatisation programmes or public-private partnership schemes; and - for several service sector firms - strategic factors associated with servicing global corporate clients. Firms with long-standing historical links are more likely to remain in times of uncertainty, even when new firms might be deterred from entry, and are important sources of additional investment over time.

Half of the firms interviewed increased the scale of (existing) operations in the past five years, and 54 percent are planning expansion in the next five. However, enterprise growth is not always accompanied by employment growth. In manufacturing, we find that rising capital intensity and improved productivity may limit the benefits of FDI in terms of ongoing job creation. On the other hand, we find that skill transfer and joint ownership of assets with local partners is taking place in the region, although most firms in the sample tend to prefer to retain management control.

There is some indication of an increase in the proportion of acquisitions in the last five years, in line with world trends, but the shift is too small to indicate a significant change, and this may be a temporary phenomenon as foreign firms take advantage of privatisation programmes. Greenfield investment continues to play an important role. The choice of ownership structure tends to reflect the preference of parent companies with respect to control of their foreign subsidiaries rather than any factors specific to the host economy or investment project.

Foreign exchange and the quality of governance are the most common risk factors identified. Foreign exchange risks include instability of exchange rates, particularly for those firms producing for local and regional markets, and availability of foreign exchange for importing inputs and repatriating profits. Concerns about quality of governance cover a range of issues, including the risk of intervention in property rights, corruption and bureaucratic uncertainty. Investors frequently argued that the “Africa perception” is a barrier to attracting new firms into the region.

5. Determinants and characteristics of FDI in Southern Africa: econometric analysis

In this section we test econometrically the findings of the descriptive analysis in section 4. The aim is to establish whether the trends identified in the survey responses have statistical significance. In some cases, sub-sample sizes are too small for meaningful results. Generally, the results are weak, but those reported below do reveal some statistical relationship between categories of foreign enterprises and relevant explanatory variables.

5.1 Methodology

The intention is to estimate the impact of a number of project characteristics on the probability of a project's belonging to a particular category. The categories (dependent variables) considered below are:

- location (the probability of locating in South Africa versus the rest of SADC)
- the mode of entry (greenfield versus acquisition)
- ownership (wholly versus part-owned)
- market orientation (local versus export)

The method used in estimating the relationship between a qualitative dependent variable (represented by a 0-1 dummy variable) and the explanatory variables is the cumulative normal function, the *probit* model. An alternative approach is the logistic function, the *logit* model.[31] These two functions are comparable; the logit model is more easily computed. However, because the probit model emerges from the normal cumulative distribution function, the tails approach the 0 and 1 axes more quickly. In other words, it more closely approximates the 0-1 function. This is the preferred model. In both models, the error term will be heteroscedastic, so that both logit and probit models must be estimated using the maximum likelihood (ML) technique, especially when individual rather than grouped data are used. Note that the R^2 is likely to be very low for this kind of regression, suggesting that the R^2 should not be used as an estimation criterion (Kennedy, 1992:229); a χ^2 test is used as an alternative.[32]

Once the probit model has been estimated, the results are used to predict the value of the dependent variable given the estimated coefficients on the explanatory variables. This predicted value can be interpreted as the (mean) probability that the dependent variable will take the value 1 (where our dependent variables are 0-1 dummies), given the characteristics captured by the explanatory variables.

5.2 Project characteristics and choice of location

The first question is whether particular investment characteristics are associated with the choice of locating in South Africa relative to other SADC economies. In sections 3 and 4 it was argued that there is a tendency for foreign investment in Southern Africa to concentrate in South Africa; we now consider whether it is possible to describe the types of firms which locate systematically in South Africa in preference to other SADC states.

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[31] In small samples with a large number of explanatory variables, computational needs may dictate the use of the linear probability model.

[32] There is, in fact, no universally accepted goodness-of-fit measure for either logit or probit estimation.

Table 5.1 describes the variables that are found to determine the probability that an investment project in our sample will be located in South Africa.

The percentage change in the relative probability (column 3 in Table 5.1) can be interpreted as the effect on the probability of an investment's being located in South Africa if the explanatory characteristic changes from being false (0) to being true (1). For example, if the market focus of the enterprise changes from supplying only the local market to supplying the regional market, there is a 46 percent greater chance of the investment's being in located in South Africa than in the rest of SADC. If the market focus is the rest of the world, the odds (at the mean) shift even more: there is a 74 percent greater probability of the investment's being located in South Africa. The clear implication is that a significant proportion of the firms locating production in South Africa intend to serve a wider - regional or global - market, and not only the domestic market.

Table 5.1: Characteristics of investment projects locating primarily in South Africa

Project characteristic	Coefficient estimate at the mean	Change in relative probability	t-statistic
Regional market	1.26	0.46	2.50
Exports to rest of world	2.23	0.74	2.58
Manufacturing	1.81	0.61	2.21
Services	1.88	0.65	2.05
Infrastructure	1.30	0.48	1.68
Exchange controls/lack of foreign exchange	-0.58	-0.20	-1.16

Notes: The change in probability is for a discrete change of location in South Africa from 0 to 1 (i.e., from failure to success), estimated at the mean (0.34).
A positive (negative) sign on the explanatory variable's coefficient indicates that a variable's switching from being false (0) to being true (1) increases (decreases) the likelihood that an investment will be located in South Africa.
Number of observations: 65
Log likelihood: -28.87
Confidence interval: 95%
Pseudo $R^2 = 0.31$; LR $\chi^2(6) = 25.47$; Prob > $\chi^2 = 0.0003$

Industrial sector also influences location in South Africa relative to other SADC countries. We find that foreign-owned manufacturing and service-sector firms are more likely to be located in South Africa than in the rest of the region, controlling for the effects of market focus. The change in relative probabilities are of a similar order of magnitude for secondary- and tertiary-sector production (61 percent and 65 percent respectively), although the effect of tertiary activities on raising the probability of location in South Africa is significant only at the 10 percent and not the 5 percent confidence level.

The effects are weaker when considering other influences on the decision to locate investments in South Africa. We report the effect of two variables: (i) the availability of adequate infrastructure and (ii) whether exchange control and/or the availability of foreign exchange is problematic for the enterprise. These are the only other variables which approach explaining in any systematic way characteristics of enterprises located in South Africa relative to other SADC states. Note that the effect of the variable which represents access to foreign exchange as a problem is negative, reducing the mean probability of the enterprise having a location in South Africa by 20 percent. This suggests that foreign exchange issues are *less* of a problem in South

Africa than in other parts of the region. But this result, though consistent in all formulations of the model, is nowhere near statistically significant.

What is interesting are those variables which are not significant. The local market dummy is rejected by the probit model because it does not permit a distinction in probabilities between South African versus non-South African investments. The reason for this is that, with the exception of the minerals sector, almost all FDI located in Southern Africa is there to take advantage of the local market whether or not cross-border markets are sought. As stated in section 4, firms locating in South Africa are *primarily* concerned with the local market, from where they expand sales into the region, and some subsidiaries successfully re-orient production towards exports to the rest of the world.

Costs - of factors and other inputs - are not found to be significant in the choice of Southern African host. This is consistent with the findings for Eastern Europe, where market seeking was found to be the primary motive for foreign investment; factor cost considerations appeared to be of less importance in the majority of investments, except those producing for export to the rest of the world (Lankes and Venables, 1997:334). Moreover, although South Africa is singled out as an investment location on the basis of superior infrastructure, a superior skills base is not found to be a consistent motivation for locating there in preference to other countries in the region.

No policy variables, neither openness to international trade nor economic or political stability, were found to explain location. The presence of exchange controls or a lack of foreign exchange is the only policy-related variable where the effects were both of a relatively stable order of magnitude and consistently negative, although, as pointed out above, the relationship is not statistically significant.

The combined effect of the investment characteristics identified in Table 5.1 reveals a 34 percent probability of location in South Africa in preference to the rest of SADC. The explanatory power of the model is low. Apart from technical difficulties with goodness-of-fit, there are practical reasons for this: many multinational corporations have firm- or country-specific reasons for choice of location; and, given the length of time over which the firms interviewed have made their original investments in Southern Africa, reasons for choice of location will have changed over time. Nevertheless, the results presented here are consistent with the descriptive findings in section 4, and with what was anticipated from the literature review in section 2. It can be concluded that market seeking is more important than cost considerations, making South Africa more attractive than its neighbours for secondary- and tertiary-sector enterprises. South Africa is also more attractive as a hub from which to export. The main location-specific reason for this pattern is superior infrastructure, both physical and financial.

5.3 Project characteristics and mode of entry

Are particular projects more likely to be initiated by greenfield investment than by purchase of existing assets? The evidence is weak, because it is difficult to establish statistical significance. However, the results in Table 5.2 below may be regarded as indicative.

Table 5.2: Characteristics of investment projects by mode of entry

	Coefficient estimate at the mean	% change in relative probability	t-statistic	Coefficient estimate at the mean	% change in relative probability	t-statistic
	Acquisition			Greenfield		
Primary sector	0.78	0.29	1.76			
Tertiary sector				1.19	0.44	3.26
Privatisation	1.03	0.39	2.30			
Regulation				0.63	0.11	1.23
Costs				0.79	0.27	1.42
Tax regime/incentives	0.48	0.18	1.12			
Notes	Mean likelihood: 0.32 The change in probability is for a discrete change of mode of entry from 0 to 1 (i.e., from failure to success), estimated at the mean (0.32). Number of observations: 65 Log likelihood: -35.10 Confidence interval: 95% Pseudo R^2 = 0.14; LR $\chi^2(3)$ = 11.60; Prob > χ^2 = 0.0089			Mean likelihood: 0.55 The change in probability is for a discrete change of mode of entry from 0 to 1 (i.e., from failure to success), estimated at the mean (0.55). Number of observations: 69 Log likelihood: -40.84 Confidence interval: 95% Pseudo R^2 = 0.14; LR $\chi^2(3)$ = 13.61; Prob > χ^2 = 0.0035		

We find that acquisitions tend to occur in the primary sector, and are frequently associated with privatisation. The sale of state-owned enterprises (including public-private partnerships) raises by almost 40 percent the probability that a new foreign investment will be an acquisition. It was posited in section 4 that privatisation might play a role in providing investment opportunities for foreign capital via acquisitions, and there is strong evidence that this is indeed the case.

We also find that those firms which identified the tax regime and/or tax incentives as important in the decision to invest are more likely to have been acquisitions (relative to greenfield investments) although this effect is very weak. Moreover, only a relatively small number of firms in the sample actually identified the tax regime as important in their investment decisions (17 percent of the sample); the correlation identified in the model reflects that, within this small subset of enterprises, there is a clear bias towards investments made by acquisition. It cannot be concluded that tax issues are an important determinant in the choice between greenfield investment and acquisition.

The combination of these characteristics predicts a mean probability of 32 percent that the FDI project was initiated by the acquisition of existing assets.

The probability of establishing a greenfield enterprise is raised by 44 percent at the mean if the planned investment is in the service sector. There are no other motivations which are significantly related to the likelihood of an investment's being greenfield, although cost structures and the regulatory environment may have some weak correlation with the decision to undertake greenfield investment.

Note that, with respect to mode of entry, location makes no difference at all; nor do variables associated with firm size, market orientation, or with most of the range of incentives offered by governments to foreign investors. In addition, the infant-industry dummy was not significantly

associated with mode of entry, which means that there is insufficient evidence to indicate conclusively a trend towards acquisitions as postulated in section 4.

5.4 Project characteristics and ownership

The next question follows from that of mode of entry: is the choice of ownership structure influenced by particular enterprise characteristics or government policies? The econometric results are very weak. This is not surprising, since choice of ownership structure was repeatedly reported to be determined by global corporate policy rather than country or project characteristics. For this reason, that some weak statistical relationships *are* found is, in itself, interesting.

The predicted probability of a subsidiary's being wholly owned, given the characteristics identified below, is 0.50 (although the R^2 and χ^2 are very small indeed).

Table 5.3: Characteristics of wholly owned subsidiaries

Project characteristic	Coefficient estimate at the mean	Change in relative probability	t-statistic
Exports to rest of world	0.99	0.38	1.74
Manufacturing	1.19	0.45	1.99
Services	1.12	0.42	1.63
Motivation: economic and political stablility	-0.94	-0.34	-1.82

Notes: The change in probability is for a discrete change of ownership from 0 to 1 (i.e., from part-owned to wholly owned), estimated at the mean (0.50).
A positive (negative) sign on the explanatory variable's coefficient indicates that a variable's switching from being false (0) to being true (1) increases (decreases) the likelihood that an investment will be located in South Africa.
Number of observations: 71
Log likelihood: -44.84
Confidence interval: 95%
Pseudo $R^2 = 0.09$; LR $\chi^2(4) = 8.74$; Prob > $\chi^2 = 0.0679$

Parent companies are more likely to retain full ownership control if their subsidiaries are producing in the secondary or tertiary sectors and exporting to the rest of the world. Even if there are doubts about the robustness of the econometrics, this is entirely consistent with the reasons given by interviewees for retaining full control, i.e., as a means of securing the integrity of the company brand name and/or reputation by ensuring consistency of quality and continuity of supply in world markets. The same reasons were given by respondents in a survey of EU subsidiaries' investments in Eastern Europe: full ownership was preferred when control of aspects of production is more important (Lankes and Venables, 1997:334).

We also find that those firms which reported that economic and political stability was an important factor in the choice of location are also less likely to have retained full ownership (evaluated at the mean). However, the subset of firms identifying stability as an important motivating factor is relatively small, and so it cannot be concluded that stability, or its absence, necessarily influences ownership decisions.

One should be wary about drawing conclusions on the basis of the probit model estimated here. Decisions about ownership are overwhelmingly taken for reasons internal to the parent firm rather than being related to country- or project-specific factors. However, though weak, the results are

at least consistent with what was reported by interviewees as being the strongest external influences on ownership decisions, indicating some pattern in the behaviour of foreign investors.

5.5 Project characteristics and market orientation

Is the market orientation of the project influenced by particular project characteristics or government policies? In particular, is the probability of producing for export, either in the region or to the rest of the world, raised by these factors?

As mentioned above, almost all subsidiaries, with the exception of primary sector firms, produce for the domestic market. What influences whether production also occurs for a wider market? The results of the probit models are presented in Table 5.4. The characteristics reported are associated with a mean probability of 49 percent that sales to the regional market will occur and of 26 percent that the subsidiary will export to the rest of the world.

Table 5.4: Characteristics of investment projects and export markets

Project characteristic	Coefficient estimate at the mean	% change in relative probability	t-statistic	Coefficient estimate at the mean	% change in relative probability	t-statistic
	Regional market			Global market		
South Africa	0.81	0.29	2.12	1.25	0.32	2.08
Primary sector				2.82	0.83	3.91
Manufacturing	0.87	0.30	2.30			
Very large firm				1.35	0.39	2.61
Infrastructure	1.03	0.39	1.66			
Incentive: tax	0.75	0.28	1.65			
Incentive: FDI				1.17	0.35	1.84
Notes	Mean likelihood: 0.49 The change in probability is for a discrete change of market from 0 to 1 (i.e., from failure to success), estimated at the mean (0.49). Number of observations: 66 Log likelihood: -32.27 Confidence interval: 95% Pseudo R^2 = 0.23; LR $\chi^2(4)$ = 19.47; Prob > χ^2 = 0.0006			Mean likelihood: 0.26 The change in probability is for a discrete change of market from 0 to 1 (i.e., from failure to success), estimated at the mean (0.26). Number of observations: 72 Log likelihood: -16.20 Confidence interval: 95% Pseudo R^2 = 0.61; LR $\chi^2(4)$ = 50.70; Prob > χ^2 = 0.0000		

The use of South Africa as a base for exporting into the rest of the region or the rest of the world was discussed above. A subsidiary is around 32 percent more likely to export to global markets if it is located in South Africa. It is also 30 percent more likely to sell output into other SADC countries if it is a secondary-sector (manufacturing) enterprise, and 83 percent more likely to export to the rest of the world if it produces primary products (minerals, agriculture or mariculture). Firm size is important for global export: very large firms employing more than1,000 workers raise the probability of exporting beyond the region by 39 percent.

Other factors which might play a role in increasing the probability that a subsidiary will export are better infrastructure, both physical and financial, and government incentives: a relatively attractive

tax regime appears to raise the probability of producing for the regional market and incentives to attract FDI appear to influence location for export to the rest of the world. These results are not strongly statistically significant, and in both cases only a small number of firms identified tax and investment incentives as important in the decision to invest, but they are worthy of note. The descriptive analysis in section 4 suggests that across all the sample incentives did not play an important role in investment decisions. The econometric evidence, on the other hand, suggests that there may be some weak correlation between the presence of incentives and the choice of market orientation.

It is possible to state with some confidence that South Africa acts as a base for production for the region and, in some cases, for successful exporting to the rest of the world.

5.6 Conclusions from the econometric analysis

As a motivation for location in Southern Africa, market seeking is more important than cost considerations. South Africa is more attractive than its neighbours for secondary- and tertiary-sector enterprises, and it acts as a base for production for the region and, in some cases, for exporting to the rest of the world. The main location-specific reason for this pattern is superior infrastructure: physical and financial. There is suggestive rather than conclusive evidence that problems with exchange controls and/or the availability of foreign exchange are more often associated with investment projects in other parts of the region, rather than in South Africa. As noted in section 4, this does not necessarily mean that investors are not concerned with foreign exchange issues in South Africa.

With respect to method of entry, the only significant explanatory variables appear to be industrial sector - acquisitions in our sample tended to occur in the primary sector; greenfield investments are more likely in the service sector - and with privatisation programmes, which obviously draw in foreign capital via acquisition.

Ownership decisions are made on the basis of parent company policy and not on conditions prevailing in host countries nor on factors peculiar to particular types of investment. There is some weak evidence that full foreign ownership occurs more frequently among secondary- and tertiary-sector firms producing for export markets, indicating that control is viewed as important for quality and consistency of supply.

Production for the regional market tends to be located in South Africa in the manufacturing sector in order to take advantage of superior infrastructure, physical and financial. Production for the global market is also most likely to occur in South Africa, in very large enterprises mainly - but not exclusively - in the primary sector. There is some weak evidence that incentives offered to foreign investors are correlated with the market orientation of an enterprise.

One important factor captured in Lankes and Venables' study of Eastern European affiliates and subsidiaries was that of economic conditions in host countries. It was found that the type of FDI varies significantly according to the host country's progress in economic transition: firms located in more advanced countries are more likely to be more export-oriented, more integrated into the foreign parent's multinational production process and more likely to exploit the comparative advantage of the host economy (Lankes and Venables, 1997:334).

In the Southern Africa survey, indicators of economic and political stability did not appear to have any influence on the probabilities of an investment's taking a particular form. One reason for this

is that economic reform in several countries in the region may still be too fragile and too recent for it to have had a marked effect on private investment behaviour, especially that of foreign entrepreneurs. Moreover, unfavourable perceptions of the credibility of reforms may well have their greatest impact on those multinational corporations which are not yet committed to investment in Africa. In other words, the existence of the "Africa perception", i.e, the view that instability is endemic across Africa, serves to undermine efforts to attract potential FDI to the region.

6. Conclusions: policy implications

6.1 Market orientation: local markets and regional integration

The primary reason for locating in Southern Africa is to take advantage of the local market. Most of the non-primary sector enterprises have a local market focus, and - with the important exception of several firms located in South Africa - these enterprises are not seeking to develop global export capacity in the medium term.

Market size is influenced by the number of people to whom goods can be distributed and the volume of their disposable income. Where domestic markets remain small, only a limited number of foreign investors are likely to enter. *Economic growth* to increase the size of the local market may therefore need to be a precursor to higher levels of FDI. In the meantime, a functioning and sustainable *free trade area* is more likely to offer the economies of scale required for investment to be profitable, and thus should encourage more direct investment in the region.

Regional economic integration will mean that the local market available to a producer in any SADC country will be significantly increased, in addition to benefits to domestic firms and consumers of reduced border delays and cheaper imported inputs. South Africa is seen by many investors to be pivotal for regional production and trade and there is a risk that much of the FDI flowing into SADC will locate in South Africa. In the debate on the role of economic integration in promoting growth in Southern Africa, there are concerns that South Africa's economic hegemony will increase with the establishment of a free trade area and, moreover, that smaller economies will lose out on prospective foreign investment to the region as further polarisation takes place, with adverse implications for growth and development prospects[33]. Regional initiatives thus need to be designed carefully to ensure the benefits of new FDI are broadly spread across the region.

These concerns raise the issue of the potential role of compensatory mechanisms to ensure that the benefits of cross border trade and investment are shared among the regional partners. The potential role of compensatory arrangements within a SADC free trade area is explored in Jenkins (2000). Here, it is argued that, to the extent that compensatory mechanisms can offset the negative aspects of the concentration of regional FDI in South Africa, then they may have positive welfare implications for the smaller economies of the region.

There are political and economic reasons to enhance the intra-regional flows of resources from core to peripheral economies in order to redistribute the gains from freeing regional trade. However, there is no strong economic argument for compensation *payments* in a free trade area, as takes place within the Southern African Customs Union, for instance[34]. Several alternatives to direct payments can ensure a more equitable distribution of the benefits of the FTA.

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[33] On the other hand, it is sometimes argued that labour legislation makes South Africa and, to a lesser extent, Zimbabwe less attractive than their neighbours as investment locations, because better statutory worker protection raises the costs of employment not only by raising wage rates but also by making firing more difficult (Maasdorp, 2000).

[34] Compensation payments are typically associated with customs unions where net exporters within the region gain at the expense of net importers because the region is protected by a common external tariff.

Where core economies attract most foreign direct investment from outside the region, *intra*-regional resource flows may be encouraged by the *removal of exchange controls*, particularly on FDI. This will enable private capital in larger economies, especially South Africa, to seek profitable investment opportunities in neighbouring countries. The partial liberalisation of exchange controls on the corporate sector in South Africa began in the late 1990s and has been more favourable for direct investments into Africa than to other parts of the world. Increased capital flows from South Africa to the smaller economies of the region should at least in part, offset the large trade surplus that South Africa has with the other SADC members, although they are unlikely to be significant in relation to the trade imbalances.

Infrastructural development on a regional basis is a further mechanism for enhancing gains from the FTA for the smaller economies and may also, in the longer term, help to encourage a more even distribution of *extra*-regional FDI. One reason why South Africa is preferred over neighbouring countries as a location for regional production is its relatively superior infrastructure. Other countries in the region need to develop *financial, electronic and physical infrastructure* in order both to stimulate domestic investment as well as attract foreign capital. This will require significant levels of investment, at a higher rate relative to population or GDP than in most other developing countries.

6.2 Market orientation: creating export capacity

Our survey findings indicate that existing markets, particularly local markets, remain the main focus of activities for most of the enterprises in the sample. Where outward orientation of existing enterprises has either taken place or is planned, these are all located in South Africa. Indeed, South Africa is shown to act as a base for production for the region and, in some cases, for successful exporting to the rest of the world.

For the smaller SADC economies, the domestic market is too limited to generate significant endogenous development. For this reason, it is crucial that production be aimed at a wider market, both regional and global; that is, that growth in production be export-oriented. Whatever its effects on poor countries, globalisation is occurring, and, if it cannot be avoided, it has to be exploited in order to deliver growth and development.

The obstacles to the globally export-oriented path of progress in Africa are both internal and external. Domestic policy is important for investment. Faster capital accumulation is vital, and this requires a reduction in the risks to private investment in both physical and human capital. It is important to recognise that risks vary across countries but policy measures include conflict resolution, greater political and macroeconomic stability, better legal systems and less corruption. This policy agenda is familiar and is also common to all developing regions irrespective of factor endowments. Where African economies face a particular challenge is in addressing the apparent perceptions of potential international investors that political and economic instability is endemic.

In addition to creating an investment-friendly policy environment, investment in research relevant to African products and conditions is vital to export-led development; in general, investment in education and training will be crucial in developing new industries. The third important factor is investment in transport and communications, which will need to be relatively high in *per capita* terms where populations are small. Expenditure on infrastructure and education is likely to be of greater importance in the long term than tax and investment incentives for investors.

External factors which are crucial include the reform of the world trading system. It is widely recognised that developing countries require greater negotiating capacity, especially within international fora, in order to press their (legitimate) concerns in the face of intransigence on the part of richer nations. Individual country efforts are unlikely to be effective, but, within regional frameworks such as SADC or wider efforts such as NEPAD, cooperation in building a united position on trade negotiations will support a strengthening of such capacity.

6.3 Perceptions of risk

The primary disincentives to locating in the region are perceptions of poor governance and volatile exchange rates and/or a lack of access to foreign exchange. In other words, foreign exchange and the quality of governance are the two most common *risk factors* identified by this sample of investors. Foreign exchange risks include instability of exchange rates, particularly for those firms producing for local and regional markets, and the availability of foreign exchange for importing inputs and repatriating profits.

For some SADC countries, volatile exchange rates are symptomatic of macroeconomic instability, and the policy priority is *economic stabilisation*. For South Africa - one of the largest emerging markets - exchange rate instability can, at least in part, be driven by international (contagion) factors outside of the control of the authorities, such that a different set of challenges exists in terms of policy responses to volatility in emerging market investment flows.

The phasing out or scaling down of *exchange controls on non-residents* in those countries where they remain, together with ensuring the *availability of foreign exchange* is essential to attracting investment. Foreign exchange availability is particularly important in terms of acquiring imported inputs and repatriating post-tax profits.

Concerns about the *quality of governance* cover a wide range of issues: intervention in property rights, the unpredictability of bureaucratic requirements and corruption. Predictable economic policies and political responses can be considered a prerequisite for FDI. Countries need to be some way along the economic transition route to attract FDI, and lags in the investment response to reforms may be very long, particularly where investors are concerned with the credibility and sustainability of policies. Investors interviewed, who by definition are already committed to FDI in SADC, frequently argued that the "Africa perception" is a barrier to attracting new firms into the region.

Finally, *government regulations and procurement policies* may deter some forms of FDI, particularly where they affect ownership. Governments need to weigh the benefits of such micro-level interventions against the costs of erecting perceived impediments to FDI, which reduce the ability of the country to compete with other developing countries for foreign investments.

Many of the motivations influencing the investment decisions of multinational companies apply equally to domestic investors. Addressing the problems identified by foreign investors already committed to the region should not only in the long run make Southern Africa more attractive to new FDI but should in the shorter term encourage increased domestic investment.

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