Foreign Direct Investment in India and South Africa: A Comparison of Performance and Policy

Introduction

India and South Africa are both large emerging economies with great potential for growth. However, neither country receives a significant amount of foreign direct investment (FDI), especially in comparison to other large emerging markets like China and Brazil. There is a feeling in government as well as civil society in the two countries that foreign investors are wrongly neglecting them. This paper seeks to identify some of the reasons for this poor performance and offers some tentative policy recommendations that might help to address their problems.

Table 1: India and South Africa: The Overall Picture

	Population in Millions 2000	GDP in US$bn 2000	% Average Annual GDP Growth 1999-2000	GDP Per Capita % Growth 1999-2000	Per Capita Gross National Income in US$ 2000
India	1016	480	6	3.9	460
South Africa	43	126	2	1.4	3020

Source: World Bank, World Development Report, 2002

Overall Performance

India and South Africa together account for a tiny proportion of world FDI flows. In 2000, South Africa received around $0.9bn while India received $2.3bn. Table 2 shows how these flows have varied in recent years.

Both countries have managed an impressive increase in FDI inflows since the early 1990s, but strong sustained year-on-year increases have not been achieved. In a regional context, South Africa receives a very large proportion of Africa's FDI flows along with three other countries, while India again performs disappointingly, coming after Thailand and Vietnam in the Asian ranking.

Both countries were hit to some extent by the contagion of the financial crisis witnessed in South-East Asia in 1997-98 as investors shunned developing markets. Now, this trend might be exacerbated by the uncertainty brought on by the September 11 terrorist attacks in the US and the overall downturn in the world economy. Graph 1 also clearly demonstrates the erratic pattern of flows into South Africa. The key reason has been the faltering momentum of the Government's privatisation programme, itself a victim of the shrunken telecoms market. The transfer of assets from the South African state-owned Telkom to the private sector in 1997 has not been followed with the sale of further shares of public sector assets, as had been planned. India's FDI performance has been flat during the second-half of the 1990s, defying hopes that the gradual liberalisation of the economy would stimulate a steady rise in investor interest.

Straight comparisons of the volumes of flows do not, of course, take into account the main determinants of FDI, the size of the market and the degree of outward orientation of the economy reflected in the volume of exports. Graph 2 shows how India and South Africa compare with selected countries, which are China, US, Brazil and Egypt in terms of the relationships between FDI and GDP, and FDI and exports.

Table 2: FDI Inflows in US $ bn to India and South Africa

Year	1989-94	1995	1996	1997	1998	1999	2000
South Africa	60	1241	818	3817	561	1502	877
India	394	2144	2591	3613	2614	2154	2315

Source: UNCTAD, World Investment Report, 2001

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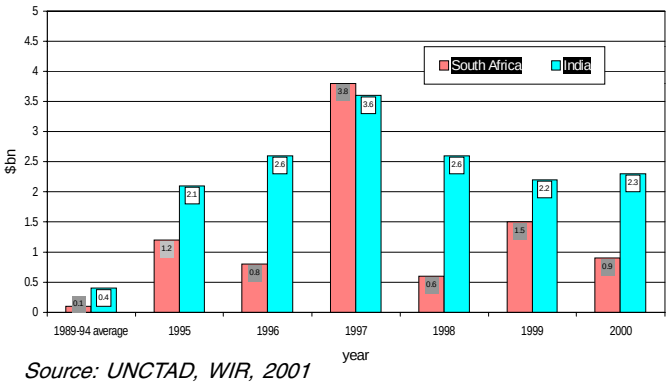
Graph 1: India & South Africa FDI Inflows in 1989-2000



Source: UNCTAD, WIR, 2001

With outward orientation taken into account, it is apparent that India and South Africa still perform comparatively badly. India receives FDI equal to below 0.5 percent of its GDP, while South Africa received 0.7 percent of its GDP in FDI in 2000. The two ratios: the country's share of world FDI to share of world GDP and to share of world exports are well below one in India and South Africa, demonstrating that they receive much less FDI than their importance in the world economy would justify.

In most developing countries, one of the key perceived benefits of FDI is a stable foreign capital inflow, creating a surplus on the capital account of the balance of payments to make up for a deficit on the current account. The net balance of FDI inflows against outflows is, therefore, expected to be strongly positive. While this is certainly the case for India, where FDI outflows are still negligible, it is not the case in South Africa where domestic businesses have been expanding rapidly, particularly into the Southern African region.

Graph 3 shows that there have been net outflows of FDI from South Africa in recent years, placing a greater strain on the country's foreign currency reserves. Although FDI inflows exceeded outflows in 2000, this was because the outflows fell even more drastically than the inflows in this period, rather than because inflows picked up.

Looking at the overall capital account, South Africa has recorded a surplus in all years since 1994, accounted for by large but highly volatile portfolio flows. These have plummeted recently as a result of regional instability and other factors, reinforcing the need for FDI as a more stable form of financial flow. India records a healthy surplus on the capital account, with portfolio flows around the same volume as direct investment flows in 1999-2000 and 2000-01.

The Role of FDI Inflows in the Economy

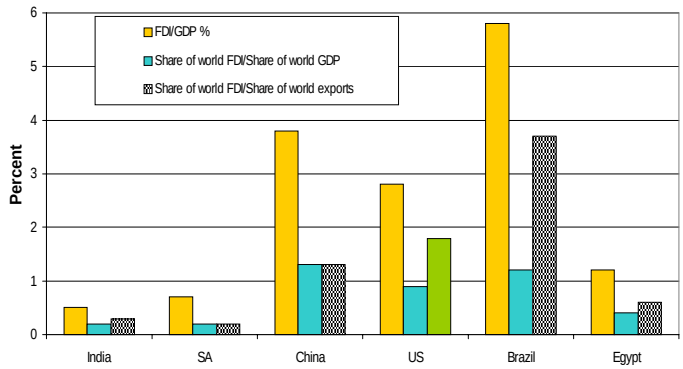
Typically, countries seek FDI not just as a form of finance, but for the unique combination of factors that it can provide. Among these are 'know how', technology and managerial skills, and access to global markets. These benefits of FDI are difficult to assess but will vary significantly from sector to sector depending on the capabilities of workers, firm size and the level of competitiveness of domestic industry. The extent to which FDI contributes to the Indian and South African economies in these ways is not investigated here, but policy-makers in both countries acknowledge that the potential benefits of FDI are significant.

The fundamental contribution of FDI to the economy should be to add to capital formation. However, this cannot be taken for granted. In South Africa, inward investment has increasingly taken the form of mergers and acquisitions (M&As) rather than 'greenfield' investment, largely as a result of the Government's privatisation programme. Table 4 shows the breakdown of FDI between types for 2000.

In India, the story has been somewhat similar, although M&As have not been driven by a privatisation drive, or "Disinvestment of Public Sector Enterprises" as this is known in India. According to the estimates of CMIE (Centre of Monitoring Indian Economy), about 50 percent of the 2000-01 inflow of FDI was accounted for either by foreign partners buying out their Indian subsidiaries or public holdings in joint ventures ("Excess focus on FDI cannot take the economy too far," P. Vinod Kumar, *Financial Express*, 02.11.01). Analysis by Saha estimates that between 1991 and 1998, about 40 percent of FDI financed the acquisition of equity stakes in existing enterprises This means that the contribution that FDI makes to capital formation is probably much lower than that suggested by the total inflow figures.

This is confirmed by the fact that in both the countries, FDI accounts for only a small proportion of gross domestic capital formation (GDCF). In India, the public sector and the domestic private sector account for almost all of the country's capital formation. Indian policy-makers hope that FDI can compensate for falling levels of public sector investment in the economy. Thus, increases in FDI flows that were achieved during the 1990s have not raised the GDCF rate as a proportion of GDP in this period, which has remained around 23 percent from 1993-94 to 1999-2000. Rates of capital formation in the manufacturing sector have actually declined in this period. In South Africa, the proportion of FDI in GDCF has fluctuated widely, reaching 7.6 percent in 1999.

Graph 2: India, South Africa & Other Countries: Comparative FDI Indices



Source: UNCTAD, WIR, 2001

Table 3: Types of FDI into South Africa in 2000	
	US$bn
Mergers & Acquisitions	774.7
Expansion	570.10
New	413.82
Intention to invest expressed by company	339.50
Investment	15.50
Disinvestment	-93.50
Source: BusinessMap online South Africa FDI database	

An examination of investment flows by sector reveals more about the kind of FDI that is entering the two countries under examination.

Table 4 shows that the bulk of investment in South Africa could be classified as resource-seeking (the food, beverage & tobacco and mining & quarrying sectors) or market-seeking (telecoms and professional services, etc.) The trends for India provide an interesting contrast See Table 5).

Throughout the 1990s, the sectors that have attracted the most interest in India for foreign investors have been fuels (taking power and oil refining together), which account for 28 percent of the total, telecommunications, accounting for another 20 percent, and transport, with over 7 percent of the total. These are all industries in which the main draw for the investor is the large domestic market. Drugs, textiles and other export industries have received only very small amounts of FDI in this period.

Policy Setting

Despite, or perhaps because of, the difficulties that both countries are having in attracting a steadily rising stream of FDI, attracting more FDI has become a preoccupation of policy-makers and it is seen as vital to meet growth targets in the coming years.

In India, the "First Generation" of reforms that were brought in in the early 1990s after the balance of payments crisis and IMF rescue-package of 1991 define the relevant macro policy context. These reforms included the liberalisation of industrial policy, which had consisted of an intricate web of licenses and permits, along with the opening up of capital markets and liberalisation of the trade regime.

These reforms have achieved some of their objectives, including restoring equilibrium to certain extent to the balance of payments and bringing down inflation. However, the impact on the real interest rate has been marginal, investment has not risen by any appreciable amount, and the economic growth rates of 7-8 percent that were achieved between 1994 and 1997 and were thought to have ushered in a new high-growth phase for the economy have not been sustained. The most prominent failure has been the privatisation programme, as only two businesses have been transferred to the private sector over the course of the decade.

The key current economic policy document for the medium-term is the Tenth Plan that was put together by the Planning Commission in 2001. This envisages a growth rate of 8 percent, fuelled largely by a rise in FDI. The document also outlines the Second Generation of reforms which include the transfer of assets to the private sector and the introduction of competition to more markets. However, these plans have met with stiff political resistance.

In South Africa, the key policy document is the GEAR – Growth, Employment and Redistribution – strategy, which was formulated in 1996. The GEAR strategy identifies a rapid expansion of non-traditional (non-mineral) exports and an increase in private sector investment (generated largely in the form of FDI) as the engines of economic growth. Thus, FDI is central to the Government's medium and long-term economic goals. GEAR estimates that gross domestic investment has to increase from 20 to 26 percent to achieve target growth rates, requiring capital inflows equivalent to 4 percent of GDP. This is expected to crowd in domestic investment and contribute to a rise in exports.

The stated goals of the South African Government are to stimulate growth, job creation and reduce inequalities in the economy. However, the macroeconomic priorities that the Government is following are reducing inflation and bringing down the budget deficit, which may, at least in the short-term, clash with the stated goals. The Government is currently facing considerable criticism because the key goals of sustained growth and job creation have not been met, even though the bulk of the policy initiatives that were envisaged have been implemented.

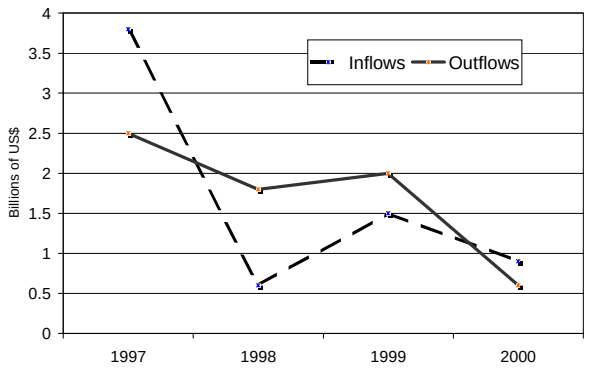
Investment Policy Overview

South Africa

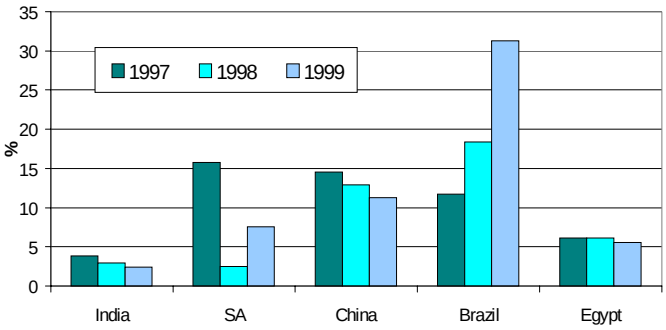
The country has undergone a thoroughgoing liberalisation of FDI policy in recent years. Now, 100 percent foreign ownership is allowed across sectors. There is an automatic approvals process for investments and a large number of Bilateral Investment Treaties with both developed and developing countries have been signed that provide for investor protection, dispute settlement, national treatment and most favoured nation treatment for foreign investors.

South Africa also has an active investment promotion agency known as TISA (Trade and Investment South Africa) which supports inward and outward investment missions and actively promotes the country as a destination for investment through a network of officials located in South African embassies in 48 countries.

Graph 3: FDI Flows in South Africa



Graph 4: FDI as a Percentage of Gross Fixed Capital Formation



Source: UNCTAD, WIR, 2001

Until recently, the South African Government rejected the use of incentives to attract foreign investors. Industrial Development Zones (IDZs), as South Africa's equivalent of export processing zones are known, allow duty-free imports and provide good infrastructure and 'world-class' management, but do not provide tax breaks. IDZs have been created in relatively under-developed regions to try to spread the positive effects of investment geographically. However, investors have not shown the expected level of interest in these zones and the lack of incentives – in contrast to those offered in other countries – is cited as one of the possible reasons.

South Africa has now introduced a wide range of schemes and incentives that are available to both foreign and domestic investors. These include preferential access to credit, tax breaks related to job creation or technology transfer, etc. In addition, South Africa has recently introduced policies to encourage the development of small and medium-sized enterprises (SME) and equitable growth:

- Public-private partnerships, innovative forms of co-operation between the public and private sectors, are being introduced to provide a range of services at the municipal and regional levels.
- Industrial clusters are being supported through the incentive schemes mentioned above and improved infrastructure. It is hoped that these will lead to spillovers of technology and skills as well as reducing regional inequalities.

In many ways, South Africa has a state-of-the-art investment policy. Public-private partnerships and clustering represent world-wide exemplary practice in investment policy-making. South Africa also has a well-resourced and developed strategy for targeting investors. Six sectors have been identified as priorities for investors from the US, while investors from Belgium, France and Switzerland are targeted for the chemicals and pharmaceuticals industries, for example. The causes of South Africa's comparative failure to attract investment must, therefore, lie outside investment policy per se. Some possible causes are discussed later.

India

In India, investment policy may be considered a meso or micro-level issue, as policies usually apply at the sectoral level or are tailored on a case-by-case basis. Requirements and incentives are defined by the Government, either at the federal, state or even municipal level, leaving significant scope for discretion on the part of policy-makers. This makes the policy environment enormously complicated and, although it may mean that the country is able to judge each investment on its own merits, opacity and unreliability in the system may also be scaring off investors.

Despite a general shift toward liberalisation of the investment regime in India, the Government maintains ceilings on the level of foreign ownership permitted in many sectors. Levels of ownership and the range of sectors have been extended gradually since 1991, when 49-percent ownership by foreigners was allowed for the first time.

There have been numerous proposals to allow 100 percent investment across a range of sectors but these have met resistance both within and outside the Government from various interest groups, leading to a high degree of inconsistency and unpredictability in the investment environment. Resistance has come from foreign investors with a foothold in the country as well as from domestic industry.

In recent months, for example, the Government proposed opening up the retail sector to foreign ownership, but the proposal was withdrawn under political pressure from opposition parties on the grounds that it would undermine the viability of small retail units. Resistance is found within the Government too, for example in relation to the liberalisation of the telecommunications sector. In June 2001, the Cabinet proposed that 100 percent foreign ownership be permitted in this sector, but the proposal was later quashed by the Communications Ministry. In January 2002, policy permitting a 100 percent FDI in the defence sector was announced.

India maintains a range of requirements on FDI including local content requirements, export requirements, dividend balancing and import limitation, which are decided on a case-by-case basis for large investments. These are outlawed by the TRIMS (Trade Related Investment Measures) Agreement at the WTO and will, therefore, have to be withdrawn before the 2002 deadline. Other measures include requirements for technology transfer and minimum investment requirements. These are being considered for the first time because of the rush of relatively small investments in the software sector that are thought to be

Table 4: Sectoral Distribution of Committed FDI in South Africa in 2000

Sector	US$mn
Food, Beverages and Tobacco	440.3
Motor and Components	361.3
Professional Services	351.7
Telecom and IT	204.7
Mining and Quarrying	208.2
Textiles, Leather and Footwear	114.6
Hotel, Leisure and Gaming	98.8
Transport and Transport Equipment	73.6
Financial Services	54.7
Media, Print and Publishing	29.9

Source: BusinessMap online South Africa FDI database

Table 5: Sectoral Distribution of Approved FDI in India 1991-2001	
	US$mn
Metals industry	3.0
Power	7.8
Oil refining	5.1
Computer software	1.2
Telecommunications	11.1
Transportation industry	4.0
Chemicals	2.6
Food processing	1.8
Financial services	2.4
Source: Saha, 2001	

less stable and, therefore, less desirable than the larger scale investments that the country has received in the past.

The Federal and State Governments have offered a number of incentives to draw in investors. Of these, the most infamous are the guaranteed rates of return that were offered to investors in large infrastructure projects such as power generation. These policies are widely considered to have been very ineffective, if not counterproductive from the point of view of investors, as much as the domestic stakeholders, as the case of Enron's investment in the Dabhol Power Company amply demonstrates. The Maharasthra State Government was committed to making payments to the company whether or not power was purchased from the DPC, but when the State's finances went into the red, the State Government was both unwilling and unable to keep up the payments. This controversy has now been overtaken by Enron's bankruptcy, but it remains an interesting case showing the dangers of unrealistic guarantees.

The Government has made efforts to streamline approvals for FDI by allowing some automatic approvals, but the process for the rest remains lengthy and onerous. The following categories of investments are required to seek approval, and a glance suffices to see that it covers a large proportion of industries that could attract potential investors:

- Investment in certain priority sectors (defence, aerospace, tobacco, alcohol, drugs and pharmaceuticals, etc);
- Investment in the manufacture of items reserved for the small scale sector;
- Where the investor has a previous joint venture or tie-up in India; and
- Cases that involve the acquisition of shares of existing Indian companies.

The initial approval process is conducted by the Foreign Investment Promotion Board (FIPB). Once the investment has been approved, the investor is then required to acquire approvals and fulfil the bureaucratic requirements of the relevant sectoral ministries such as the Ministry of Energy or the Ministry of Communications as well as environmental and planning approvals. The Government is considering replacing the FIPB with a 'Foreign Investment Implementation Authority', which would provide a range of follow-on services for investors, in particular assisting them in securing the required extra approvals. This might help to raise the disappointing 50 percent fructification rates (actual investments compared to investments approved) that India currently achieves.

The Investment Environment

In South Africa and India, as in all countries, investment policies are only a small subset of the economic, social and political characteristics that affect the investments that a country attracts. In the case of South Africa, the liberal investment policy regime has not been sufficient to attract investors. Below, some possible reasons for the comparative lack of success are suggested. In India, other policies exacerbate the restrictions and difficulties imposed by the investment policies.

South Africa

Investor surveys have shown that current investors tend to be satisfied with the investment environment and express their intentions to make further investments. The Chairman of Daimler Chrysler, for example, which has invested heavily in new plant in South Africa, has given South Africa resounding commendations as an investment destination. However, potential investors cite a number of reasons for their reluctance to invest in the country, which include:

- Stagnant market, reflected in low economic growth rates;
- Uncertainty/lack of confidence reflected in low rates of domestic savings, domestic investment and the recent listings of several South African companies on foreign stock exchanges (e.g. Old Mutual, Anglo-American Corporation, South African Breweries and Digital Data have all been listed on the London Stock Exchange);
- Regional instability in particular, the events in Zimbabwe, which have coloured investors' perceptions of the entire region and undermined trust in property rights;
- A high crime rate, which has a negative psychological effect and raises the costs of doing business as well;
- Lack of political will: while the current ANC Government is committed to economic growth, driven by the private sector, the South Africa Communist Party and COSATU (Confederation of South African Trade Unions), which form part of the ruling coalition, oppose the privatisation programme and openly reject the role of the private sector in some areas of the economy. Until now, the promise of growth and employment has kept these parts of the coalition behind the Government, but the apparent failure of policy to fulfil expectations is fuelling dissent. This may make it difficult for the Government to continue with its policy programme;
- Quality of the workforce – Investors have expressed some concern about the skill levels in large parts of the workforce, but the more immediate problem is the AIDS pandemic that affects a large proportion of the economically active sections of the population. The scale of the problem is coupled with the Government's perceived failure to take the necessary radical policy steps to deal with it; and
- Labour policy – South Africa has strong and active unions that have high status in the country because of their role in the overthrow of the apartheid regime. Opposition of organised labour is likely to create a major roadblock to future privatisation while strikes continue to create disruption in the economy.

This long list demonstrates that South Africa will have to take a much broader approach to improving the investment environment, if it is to attract higher FDI flows. In particular, policies to control AIDS and crime would be extremely valuable in themselves, as well as having positive knock-on effects on investment. Another priority for South Africa, given its significant outward investment flows, is to take a regional approach to attracting investment. The Government is already pursuing this. The South African Development Community (SADC) is developing a Finance and Investment Protocol for co-operation on financial matters that will take account of the different levels of economic development in the member-countries. A Working Group will be drafting the protocol over the next few years.

India

The positive perception held by current investors in South Africa provides a stark contrast with India, where many high-profile investors have withdrawn after difficult experiences. WorldTel, Cogentrix and Enron provide just a few examples. In India, as in South Africa, other factors outweigh the importance of investment policy per se in determining whether investors come – and stay – in the country.

The most commonly cited problems are bureaucratic red-tape and a lack of firm political will, which slows down the pace of reforms. Among the most urgent reforms that are needed in the Indian economy is the reform of the Small-Scale Industries policy. This inhibits economic restructuring and efficient allocation of labour in the economy and makes it very difficult even for good managers to improve the efficiency and productivity of their businesses. Efficiency-seeking M&As, whether by foreign or domestic firms, are stifled by the policy.

Policies to support small and medium-sized enterprises (Small Scale Industries or SSIs in India) were motivated by the wide geographical spread of the productive units of the sector and by its capacity to generate employment. A maximum level of investment defined SSIs and certain sectors, including potential key export sectors like textiles, were reserved for SSIs. This created a highly distorted set of incentives for managers, as successful SSIs were not able to grow because of the investment caps, while poorly performing companies were kept alive. It also discouraged foreign investment in the reserved sectors.

The most disappointing performance has been in the Government's privatisation programme. Almost half of India's productive assets remain under state control and large proportions of these are key infrastructure assets. Many of these public sector companies are generally less efficient than their private counterparts. For example, India's state-owned electricity companies lose 40 percent or more of their power compared to 10 percent for private distributors. Government budget constraints mean that levels of investment in infrastructure are totally inadequate, discouraging both foreign and domestic investment.

There are numerous other complications and contradictions in Indian policy which justify investors' objections to bureaucracy in India. Regulations governing power and telecommunications, in particular, are complex and often inconsistent.

The state of property markets, currently closed to foreign investment, also suppresses efficiency in the economy. Currently, as many as 90 percent of land titles in the country are under dispute of some form, and high stamp duties give India the highest property prices in relation to income in Asia. Simply changing the investment regulations to allow FDI in real estate would clearly not be adequate to draw foreign investors into property development in India.

Conclusion

India and South Africa are two excellent examples of countries with enormous economic potential that do not achieve the rates of investment that they need to realise this potential. In both cases, determined policy reform by the Governments could make a huge difference. But, as the discussion above demonstrates, it is not investment policy on its own that matters. Rather, it is the investment environment taken as a whole. In general, the same policies that would help to raise domestic investment, create the right incentives for managers, reduce distortions and raise efficiency in the economy would be the same ones that would attract more FDI. Policy coherence also stands out as a pressing need in both countries to reduce the current incidence of contradiction and confusion. Furthermore, the Governments will need to fill in policy gaps where bureaucratic discretion and ad hoc decision-making takes the place of a clear and consistent regulatory environment.

In both countries, there are significant groups in the public sector and in civil society that oppose further economic reforms. If policies are to be effectively carried through from paper to practice, the Governments will have to spend time on winning over these groups and creating a strong domestic opinion in favour of reforms. The public has much to gain from increased foreign investment governed by an adequate regulatory regime but their views are often coloured by the negative publicity that surrounds particular cases. Providing balanced information to civil society and encouraging an open national debate on investment issues would help create the necessary pressure for beneficial reform.

This paper draws on the reports prepared by Biswatosh Saha, Indian Institute of Technology, Kharagpur, India, and Brendan Vickers, Institute for Global Dialogue, South Africa, on India and South Africa, respectively, both 2001, for the "Investment for Development" project being carried out by CUTS.

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