Investment Policies in Select Large Emerging Markets

– Performance and Perceptions

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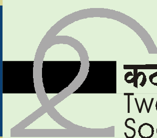

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0335

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– Performance and Perceptions

कट्स CUTS

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LIST OF ABBREVIATIONS

ADR	American Depository Receipts
AIEC	Automotive Industry Export Council
BITs	Bilateral Investment Treaties
BNDES	Economic and Social Development National Bank
BOP	Balance of Payments
DTI	Department of Trade and Industry
EU	European Union
FDI	Foreign Direct Investment
FII	Foreign Institutional Investment
FIPB	Foreign Investment Promotion Board
GATS	General Agreement on Trade in Services
GDR	Global Depository Receipts
GEAR	Growth, Employment and Redistribution
IDC	Industrial Development Corporation
IIC	International Investment Council
IMF	International Monetary Fund
IS	Import Substitution
IT	Information Technology
M&A	Merger and Acquisition
MERCOSUR	South American Common Market–member countries are Argentina, Brazil, Uruguay, and Paraguay
MIDP	Motor Industry Development Programme
MNCs	Multi-national Corporations
MUL	Maruti Udyog Limited
NCAER	National Council of Applied Economic Research
NTB	Non-tariff Barriers
OEM	Original Equipment Manufacturers

PICE	Programme of Economic Integration and Co-operation – it is one of Brazil's industrial and foreign trade policies
RBI	Reserve Bank of India
SA	South Africa
SBDC	Small Business Development Corporation
SIA	Secretariat for Industrial Assistance
SMEs	Small and Medium Enterprises
TDCA	Trade, Development and Co-operation Agreement
TISA	Trade and Investment South Africa
TNC	Trans-national Corporation
TRIMs	Trade-related Investment Measures

FOREWORD

Developing countries in 1990s adopted policies to welcome FDI, which signaled a change in their attitude since earlier FDI was not a favoured source of foreign capital. Countries now compete with each other fiercely and provide incentives to foreign investors to attract higher FDI into their countries. The change in attitude can be explained by the fact that aid to developing countries has fallen in this period as well as some developing countries have been able to extract benefits from foreign investment.

In the past decade multinational enterprises (MNEs) have rapidly expanded their productive activities across the globe. Today they have a command over the most productive segments of the world economy. The average productivity of workers from MNE affiliates is higher than that from local firms. Recent estimates put this figure at about seven times. The margin in developing countries is even greater, perhaps as much as 15 times the average output per worker. Productivity figures of MNE affiliates in developing countries reflect the figures in the parent firms. Indeed MNE plants in emerging markets are often the world leaders in productivity.

FDI may raise the productivity of capital in host countries by a larger degree by introducing efficient methods of production than that introduced by local firms. Further, FDI may promote growth by introducing new forms of productive activities and stimulating its exports.

Productivity gains for the host country may also take place due to spillover effects, which are productivity advances passed on from foreign affiliates to locally owned firms. Locally owned firms may increase their efficiency by adopting marketing or managerial know-how of foreign firms to raise profits, to increase exports or to merely survive in the domestic market.

One point is worth noting that benefits of FDI can be accrued only when the domestic market is competitive rather than being monopolised by either domestic players or MNE affiliates.

In the light of growing importance of FDI in developing countries Consumer Utility & Trust Society (CUTS), Jaipur with the support of Department for International Development (DFID), UK and, in collaboration with the United Nations Conference on Trade and Development (UNCTAD) has undertaken a study to analyse the investment regimes of seven developing/transition economies and build capacity of civil society on these issues. The emphasis is on co-operation between countries and within regions, sharing information and experience and engineering joint initiatives. The National Council of Applied Economic Research (New Delhi) is working with CUTS as the partner organisation in India. I would like to thank CUTS for its continuing partnership with NCAER in areas of common interest.

This report attempts to compare and contrast the national regulatory regimes and policy issues relevant to FDI in three large emerging economies, namely, Brazil, India and South Africa with a view to build capacity and awareness in investment issues and draw out the lacuna of the present system. The study is based on existing literature along with feedback obtained from surveys of stakeholders, namely civil society groups and local firms.

I am thankful to Dr. Sanjib Pohit, Ms. Shalini Subramanyam and Ms. Sowmya Srinivasan for their hard work in preparing this report. Authors would like to acknowledge the research assistance and computer support of Somnath Mukherjee, Nupur Pande, Devender Pratap and Praveen Sachdeva of NCAER.

December 2003
New Delhi, India

Suman Bery
Director General
NCAER

PREFACE

Foreign direct investment (FDI) was an important aspect of globalisation in 1990s. Between 1990 and 2000, global FDI inflows increased by about ten times. This increase was faster in large developing than other developing countries. FDI inflows across the globe have been uneven with developed countries followed by large developing countries having a larger share in the flows than the other countries.

Large developing countries or large emerging markets (LEMs) experienced an interesting pattern in inward FDI. Many of them received a large proportion of FDI due to their privatisation programmes with an increasing share in the tertiary sector. Earlier governments were deeply involved in many of the tertiary sector activities such as electricity transmission and distribution, water delivery, transport services, telecommunication services etc. Governments were also involved in the manufacturing sectors in various countries in varying degrees. The 1990s wave of globalisation and liberalisation, and restructuring of government activities, led many developing countries to open the state-run sectors to domestic and foreign private firms. This opened up profitable opportunities for foreign investors, especially large transnational investors such as Enron, Vivendi or Vodafone, in these countries.

However, many such privatisation and restructuring efforts have gone awry due to policy ineffectiveness. Sometimes the efforts did not succeed due to external factors also, such as the slowdown in the world economy. Further, LEMs adopted facilitative policies for foreign investors in 1990s for sectors other than the ones run by the state. Some countries have been more successful than others in facilitating FDI. It is very important to study the experiences of LEMs in facilitating FDI to find out which formula for policy and regulatory changes clicks more than the others and prescribe policy options for other such countries.

This report studies investment regimes of three LEMs: Brazil, India and South Africa, each with different characteristics and experiences with FDI. It compares the FDI policies, performance and perceptions in the three countries and recommends some policy and action changes to facilitate FDI, which would promote economic growth and development.

The report throws up interesting findings too. For example, Brazil received relatively high FDI mainly in its services industries, but that did not have a favourable impact on the country's economic growth. South Africa experienced very little inward FDI, indeed domestic investment, but it was the biggest foreign direct investor in Africa. India, despite taking favourable measures to facilitate FDI, lagged behind compared to many other economies of its size in attracting FDI due to poor implementation of policy and regulatory measures.

As a unique experience the case of India can be highlighted further. The country adopted a disinvestment policy for the state-run units, which included acquisition of shares of a state-run enterprise by another. It also included off-loading of shares in the domestic stock market to bring about a wider public participation. Therefore, the Indian disinvestment policy did not target foreign investors specifically, unlike in South Africa and Brazil. The country also opened up a few sectors to foreign investors without diluting the role of the state in the sector e.g. in telecommunications.

A number of studies and reports, such as the Report of the Steering Group on Foreign Direct Investment by the Planning Commission, Government of India under the chairmanship of N. K. Singh, Member of the Planning Commission (popularly known as the N. K. Singh Committee Report), have already examined these issues. The present report would add to the existing literature and reiterate some of the suggestions and recommendations.

This report has been prepared as part of a seven-country two-year project "Investment for Development" implemented by Consumer Unity & Trust Society with the support of the Department for International Development (DFID), UK and in collaboration with the UNCTAD.

CUTS would like to thank the authors Sanjib Pohit, Sowmya Srinivasan and Shalini Subramanyam of the National Council of Applied Economic Research (NCAER), New Delhi for preparing the report. The authors as well as CUTS would like to thank Suman Bery, Director-General, NCAER; John Dunning, Emeritus Professor of International Business, University of Reading, UK; Brendan Vickers, Institute of Global Dialogue, South Africa and Mariano Laplane, Instituto de Economia, Nucleo de Economia Industrial e da Technologia, University of Campinas, Brazil for their comments. I would like to add my gratitude to my colleagues at CUTS: Rajeev D. Mathur, Nitya Nanda and Sanchita Chatterjee for their contributions in critiquing the report and adding value to it.

December 2003
Jaipur, India

Pradeep S. Mehta
Secretary General
CUTS

CHAPTER-1

Introduction

Many developing countries, once hostile to the entry of foreign direct investment (FDI), or inclined to restrict it severely, now compete to attract foreign firms. FDI is now considered to be an important instrument through which economies are integrated at the level of production into the globalising world economy by bringing a package of assets, including capital, technology, managerial capacities and skills, and access to foreign markets. It also stimulates technological capacity-building for production, innovation and entrepreneurship within the larger domestic economy through catalysing backward and forward linkages[1].

The trade effects of FDI depend on whether it is undertaken to gain access to natural resources or consumer markets and whether it is aimed at exploiting the dynamic comparative advantage of the host country and/or other strategic assets it possesses, such as research and development capabilities[2]. By its very nature, FDI brings into the recipient economy resources that are only imperfectly tradable in markets, especially technology, management know-how, skilled labour, access to international production networks, access to major markets and established brand names. In addition, FDI can make a contribution to growth in a more traditional manner, by raising the investment rate and expanding the stock of capital in the host economy. It is, thus, now widely recognised by governments that FDI can play a key role in economic growth and the structural transformation process.

There are areas, however, in which the impact of FDI can be negative, e.g., in cases where competition is stifled, restrictive business practices are used or transfer prices manipulated. Small economies, furthermore, may need to guard against too much FDI too quickly, as flows of FDI that are too large given the absorbing capacity of the host economy are likely to bring about negative side effects such as the appreciation of the exchange rate, which, in turn, has a negative impact on export and development. The impact can also be sub-optimal; this is the case where FDI leads merely to the exploitation of static comparative advantage and to a continuing reliance on existing local endowment. Of course, it is possible to optimise the impact of FDI by appropriate policies aimed at encouraging the full exploitation of dynamic competitive advantages through the upgrading and strengthening of the domestic productive and technological bases.[3]

The effects of FDI on development depend on the initial conditions prevailing in the recipient countries, on the investment strategies of TNCs and on the host government's policy goals and aspirations. Governments, therefore, cannot be passive. The contribution that FDI makes to development can be enhanced by policies that do not remain confined to the mere liberalisation of FDI regimes and the granting of legal protection and guarantees to foreign investors. Indeed, there exists a wide array of policies that can be used to stimulate greater learning, innovation and linkage effects as well as to promote trade and employment gains. Government actions need to be aimed at fostering, channelling and complementing FDI. Beyond these challenges to national policy, the growth of FDI and the emergence of integrated international production systems raise a number of new policy issues which, increasingly, require international attention (UNCTAD, 1999).

Brazil, India and South Africa (SA) are all large emerging economies with great potential for growth. All the three countries have seen an increase in FDI inflows in the 1990s. In the 1970s and 1980s, there was hardly any foreign investment in India and South Africa and, while the inflow in Brazil was slightly higher than in India and South Africa, it remained only a very low percentage of the global FDI flow.

This report has been prepared under the "Investment for Development" project, which is a two-year project implemented by Consumer Unity & Trust Society, Jaipur, India with the support of Department for International Development (DFID), U. K. and in collaboration with UNCTAD. This report attempts to compare and contrast the national regulatory regimes and policy issues relevant to FDI in the above three large emerging markets, namely, Brazil, India and South Africa, with a view to building capacity and awareness in investment issues and drawing out the lacuna of the present system. The study is based on the existing literature, along with the feedback obtained from surveys of stakeholders, namely, civil society groups and local firms. It also compares the performance of an important sector experiencing major changes in 1990s in the three countries.

The report is organised into nine chapters. After a brief introduction in chapter 1, chapter 2 discusses trends, determinants and measurement issues related to FDI. Chapter 3 is devoted to the macroeconomic context for FDI, while chapter 4 deals with sectoral distribution of FDI with source countries. Chapters 5 and 6 cover investment policy audit and competition for FDI. Chapter 7 covers civil society perceptions. Chapter 8 discusses the automobile sector. Finally, chapter 9 covers some recommendations and conclusion.

CHAPTER-2

FDI Flows: Ways, Determinants and Measurement Issues

A firm can undertake FDI in a host country in either of two ways: greenfield investment in a new facility, or acquiring or merging with an existing local firm.[4] The local firm may be private or state-owned. Privatisation involving foreign investors counts as cross-border M&As, which entail a change in the control of the merged or acquired firm. In a cross-border M&A, the assets and operations of two firms belonging to two different countries are combined to establish a new legal entity. In a cross-border acquisition, the control of assets and operations is transferred from a local to a foreign company, the former becoming an affiliate of the latter.

Distinction of FDI on the basis of three major motives of the trans-national corporations (TNCs) for undertaking FDI in developing countries are: import-substituting FDI, export-increasing FDI and government-initiated FDI[5] . Import-substituting FDI involves the production of goods previously imported by the host country, necessarily implying that imports by the host country and exports by the investing country will decline. This type of FDI is likely to be determined by the size of the host country's market, transportation costs and trade barriers. Export-increasing FDI, on the other hand, is motivated by the desire to seek new or more economical sources of input, such as raw materials and intermediate goods[6] and to exploit the comparative advantage of the host country. This kind of FDI is export-increasing, in the sense that the host country will increase its export of raw materials and intermediate products to the investing country and other countries (where the subsidiaries of the multinational corporation are located).

Government-initiated FDI may be triggered, for example, when a government offers incentives to foreign investors in an attempt to attract foreign capital. In this case as well, the net benefits to the host country consist of the value added by the foreign investment, less the cost of fiscal incentives offered. These incentives may consist of trade-restructuring measures such as tariffs and other protective devices as well as subsidies and taxes and can create conditions under which it is more profitable to produce in, rather then export to, a foreign country. Other FDI can be quite footloose, moving on when the

incentives expire. There is vast literature on the factors which drive FDI into country A rather than country B. On the basis of work done by Prof. John Dunning of the University of Reading and the UNCTAD, the host country determinants can be classified into three categories, viz. Policy Framework of FDI, Economic Determinants and the Facilitation Factors (see Table 1). The shaded parts of the Table represent those determinants of FDI, which have become more important over the years. For instance, as we will see later, factors such as investment incentives and promotion schemes and the availability of skilled labour have assumed a greater role in India, in the recent years. In Brazil, the privatisation policy has gained increasing importance as a factor determining FDI flows into the country.

It is important to note that there are significant problems with the definition and interpretation of FDI data in different countries. According to international guidelines based on the recommendations by the International Monetary Fund (IMF) in its *Balance of Payments* manual (fifth edition, 1993), FDI is defined as international investment that reflects the objective of a resident entity in one economy (foreign direct investor or parent enterprise) obtaining a “lasting interest” and control in an enterprise resident in an economy other than that of the foreign direct investor. “Lasting interest” implies the existence of a long-term relationship between a direct investor and the enterprise, and a significant degree of influence on the management of the enterprise[7]. The general rule of thumb presented in the *Manual* is that the direct investor owns (or controls) at least 10 percent of the ordinary shares, voting power or equivalent. FDI flows are the sum of three basic components, viz., equity capital, reinvested earnings and other capital associated with various inter-company debt transactions.

FDI flows are recorded on a net basis (capital account credit less debit between direct investors and their foreign affiliates) in the Balance of Payments. Liabilities represent the source of funding, which covers loans, capital and reserves and profits brought forward. Assets represent the use of funds that involve the act of investment by the company to acquire plant and machinery, real estate, etc. According to the IMF guidelines, FDI is defined as a source of capital funds from the host country’s point of view and it need not necessarily imply immediate addition to plant and machinery or stocks.

In general, the IMF guidelines are followed closely by industrial countries, but not completely by many developing countries, due to difficulties in compilation of FDI data. For example, in the case of India, FDI statistics are published by two official sources: the Reserve Bank of India (RBI) and the Secretariat for Industrial Assistance (SIA). The definition of FDI and computation of its

statistics used by the RBI does not conform to the guidelines of the IMF. The difference is that India excludes reinvested earnings in its estimate of actual FDI inflows. It also does not include the proceeds of the foreign equity listings and foreign subordinated loans to domestic subsidiaries which, according to the IMF guidelines, are part of inter-company loans (long and short-term net loans from the parent to the subsidiary) and which should be a part of FDI inflows. India also excludes overseas commercial borrowings, whereas according to the IMF guidelines, financial leasing, trade credits, grants, bonds, etc., should be included in FDI estimates. As per the IMF, if a shareholding of 10 percent or more is acquired eventually by a non-resident who entered initially through the portfolio route but holds investment aggregating over 10 percent through the purchase of additional shares in subsequent transactions, those additional shares should be regarded as a part of FDI. However, in India, individual foreign institutional investors (FIIs) hold well over 20 percent of the equity in the form of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs), but these are not a part of FDI.[8]

In this connection, it is necessary to understand and draw a distinction between FDI and portfolio investment. FDI involves the transfer of a bundle of resources, e.g., technology, management skills and capital under the same ownership. As against this, portfolio investment is a purely financial investment, without any necessary long-term commitment. Recently, the IMF has acknowledged the need for careful policies that monitor and in some cases, regulate capital flows of this nature. However, portfolio investment may create several benefits for the host economies. It provides additional capital and helps the recipient firms become more productive. Typically, such firms yield higher returns to investors. This creates competition for other firms in the industry. Thus, the economy becomes more efficient, due to portfolio inflows.

Table 1: Host Country Determinants of FDI

Host Country Determinants	Type of FDI by Motives of TNCs	Principal Economic Determinants in Host Countries:
1. Policy Framework for FDI • Economic, political and social stability • Rules regarding entry and operations • Standards of treatment of foreign affiliates • Policies on functioning and structure of markets (especially competition and M&A policies) • International agreements on FDI • Privatisation Policy • Trade Policy (tariffs and NTBs) and coherence of FDI and trade policies • Tax policy (including tax credits) • Industrial /Regional Policies	**A. Market-seeking**	• Market size and per capita income • Market growth • Access to regional and global market • Country-specific consumer preferences • Structure of markets
2. Economic Determinants	**B Resource-seeking**	• Land and building cost, rents and rates • Cost of raw materials, components, parts • Low-cost, unskilled labour • Availability & cost of skilled labour
3. Business Facilitation • Investment incentives and promotion schemes • Reduced information costs • Social amenities (bilingual schools, quality of life, etc.) • Pre and post-investment services (e.g., one-stop shopping) • Good infrastructure and support services, e.g., banking, legal, accountancy etc. • Social capital; economic morality • Region-based cluster and network promotion	**C. Efficiency-seeking**	• Cost of resources and assets listed under B (Resource-seeking) adjusted for productivity of labour inputs • Other input costs, e.g., transport and communication costs to and from and within host economy • Membership of a regional integration agreement conducive to promoting a more cost-effective inter-country division of labour
	D. Asset-seeking	• Technological, managerial, relational and other created assets • Physical infrastructure (ports, roads, power, telecommunications) • Macro-innovatory, entrepreneurial & educational capacity/environment

CHAPTER-3

Macroeconomic Context for FDI

This chapter provides a brief macro-view of the three large emerging markets, namely, India, Brazil and South Africa, in terms of their economic performances, policy regimes and FDI flows.

Brazil is the biggest country in South America, in terms of size, population and economic performance. With a population of 170 million and a per capita gross national income of US$3580 in the year 2000, the country had an average annual GDP growth rate of 1.8 percent for the period 1990-99 (see Table 2). The potential of the Brazilian economy is magnified by the consolidation of the regional market. The Common Market of the South (MERCOSUR) was created in 1991 as a customs union amongst Brazil, Argentina, Uruguay and Paraguay and has an estimated market of 215 million population. Brazil was responsible for somewhere between 40-50 percent of the flow of FDI directed to the MERCOSUR at the start of the 1990s, or further still, 40 percent of the total flow of FDI to Latin America in 1998.

In 2000-01, India's GDP was around US$510bn. In the year 2000, the per capita gross national income stood at US$450 (see Table 2). The 1990s have seen a marked increase in private capital flows to India, a trend that represents a clear break from the two prior decades. In the 1970s, there was hardly any new foreign investment in India: indeed some firms left the country. Inflows of private capital remained meagre in the 1980s: they averaged less than US$0.2bn per year from 1985 to 1990. In the 1990s, as part of the wide-ranging liberalisation of the economy, fresh foreign investment was invited in a range of industries. Inflows to India rose steadily through the 1990s, exceeding US$5bn in 2000-01.

South Africa is a middle-income developing country, with an estimated per capita gross national income of US$3020. However, in the period 1990-99, GDP per capita grew at -0.7 percent (see Table 2). Also, the South African society is plagued by deep socio-economic inequalities. Nevertheless, despite the small size of the market, it has, in recent years, shown an increase in purchasing power and a high propensity to consume. The SA market, moreover, accounts for 50 percent of the purchasing power of Africa[9]. Changing consumption patterns suggest a shift in favour of goods and services produced by the

tertiary sector, providing a stimulus to the transport, entertainment and telecommunication industries. Real final consumption expenditure by households grew by year-on-year rates of above 3 percent during 2000. The steady strengthening of consumer spending is primarily due to an overall general decline in interest rates (interest rates were raised to 14 percent in January 2002, due to the depreciation in the value of the rand), income growth and a lower effective income tax rate on individuals.[10]

Table 2: Brazil, India and South Africa: The Overall Picture

	Population in Millions 2000	**Per Capita Gross National Income in US$ (2000)**	**GDP Per Capita Percent Growth (1990-1999)**	**Percent Average Annual GDP Growth (1990-1999)**
Brazil	170	3580	0.4	1.8
India	1016	450	3.7	5.6
South Africa	43	3020	-0.7	1.3

Note: Valued at current exchange rate

Source: World Bank, World Development Indicators, 2002.

Turning to the growth of FDI inflows, we find that there has been a significant growth of FDI flows and stocks in Brazil. The already significant participation of foreign capital in the Brazilian economy, measured on the basis of the stock of foreign capital accumulated throughout several decades and present in various sectors of the economy, has increased even further, with the recent flows of FDI. The stock ratio between FDI/GDP in the case of Brazil doubled in the last two decades (7.4 percent in 1980, against 15.9 percent in 1997). The ratio of FDI to gross domestic capital formation (GDCF) was 31.1 percent in 1999.[11]

As against this, FDI accounts for only a small proportion of the GDCF in both India and South Africa. 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 the 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 the GDP, in this period, which had remained around 23 percent from 1993-94 to 1999-2000.

In South Africa, the proportion of FDI in the GDCF had fluctuated widely, reaching 7.6 percent in 1999.[12]

Table 3 shows how FDI inflows have varied in recent years in the three LEMs, comparing the figures with those of China and the world. We can see that China has the highest share in FDI inflows. After remaining at a level of US$2bn in the early 1990s, FDI flows into Brazil reached a value close to US$30bn in 1999. The rhythm of growth observed in the inflows of FDI to Brazil in this period was far superior to the growth of the global flow of FDI, resulting in a growth of the Brazilian participation in the total flow.[13] However, neither India nor South Africa has received a significant amount of FDI, when compared with other large emerging markets like China and Brazil. India and China are the two largest Asian countries that launched liberalisation programmes around the same time. While the Chinese policy resulted in a sharp increase and persistent growth in their exports, favourable trade balance, huge FDI inflows, high investment rates, and a leading role in the global economy, the Indian performance has been poor, despite the liberalisation policies. The Indian FDI inflows have been meagre and there has been a marked slowdown in crucial economic indicators since the mid-1990s.

Table 3: FDI inflows in US$ mn

Year	1990-95	1996	1997	1998	1999	2000	2001
World	225321	386140	478082	694457	1088263	1491934	735146
Brazil	2000	10792	18993	28856	28578	32779	22457
China	19360	40180	44237	43751	40319	40772	46846
India	703	2525	3619	2633	2168	2319	3403
S. Africa	301	818	3817	561	1502	888	6653

Source: UNCTAD, World Investment Report, 2002.

Two global developments, both, concerning recent FDI flows in East Asia are important in this regard. One is the resilience of the flows even during the period of economic crisis. Another important development is the increase in mergers and acquisitions (M&As), as a mode of entry, particularly after the East Asian economic crisis (United Nations, 1999). The reason being that developing East Asian economies, with a keen interest in attracting FDI, relaxed the restrictions on FDI. Also, the huge depreciation of East Asian currencies, which reduced the value of assets in foreign currency, encouraged TNCs to undertake M&As.

Box A: The Chinese Experience

China started its economic reforms in 1978, with the launching of four modernisation programmes by means of de-collectivisation of agriculture and authorisation of private enterprises. The programmes mainly involved technological upgradation and modernisation of small and medium enterprises (SMEs). This was mainly achieved through technology transfer and FDI in SMEs. The Chinese, perhaps rightly, perceived that for an effective transfer of technology, foreign firms must have at least a 25-percent equity stake in Chinese SMEs. Therefore, they prescribed a floor-level of 25 percent foreign equity in the SMEs. In 1984, China authorised 22 cities to set up technological and economic zones to attract FDI and permitted cities and provinces to directly negotiate FDI. As a result of efficient functioning of its institutions, China is able to attract enormous amounts of FDI. Currently, it is the fourth-largest recipient of FDI inflows (after the US, the UK and Sweden).

In the 1980s, China received FDI mostly in the service sector. In the 1990s, however, most of the investments have been in the manufacturing sectors and have contributed enormously to Chinese exports. FDI exports to total Chinese exports in 1999 stood higher than 45 percent. In 1999, about 28 percent of the total industrial output was contributed by FDI ventures. China's impressive export performance is mainly due to their successful modernisation programme and FDI policy and their programme of improving the efficiency of their institutions like customs, ports, transport, banks and others relating to exports.

Sources: N. S. Siddharthan, March 2001, *"Globalisation and the Budge –Urgent Need for Institutional Reforms"*, Economic and Political Weekly.

Shujiro Urata, *"Emergence of an FDI-Trade Nexus and Economic Growth in East Asia"*, in Joseph Stiglitz and Shahid Yusuf (Eds.), 2001, *"Rethinking the East Asian Miracle"*, Oxford University Press.

There has been much debate about whether or not there was an East Asian miracle and, if there was, what contributed to it and whether there are lessons that are applicable to other regions. By the same token, there has been much debate about what caused the East Asian crisis, what lessons should be drawn from that experience and what insights the crisis itself sheds on the economic developments of the preceding three decades. As countries have recovered from the crisis – some more quickly than others – the debate has not diminished. Some have viewed the quick recovery as evidence of these countries' long-

standing strengths, others view it as bearing testimony to the wisdom of the reforms that had been urged upon them in the midst of the crisis[14].

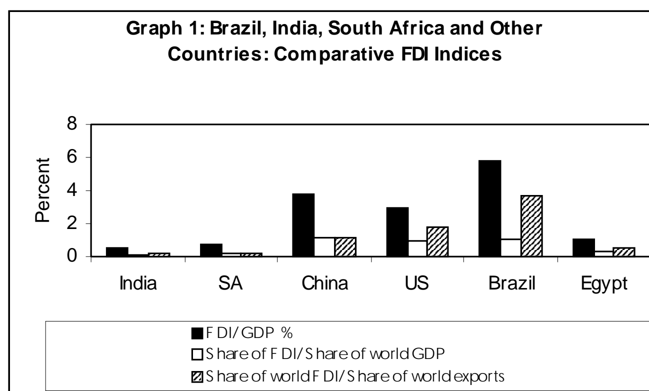
In this context, the Chinese experience is worth a mention. Between 1978 and 1998, China achieved about 9 percent growth, accounting for about two-thirds of all growth in the world's low-income countries. On a per capita basis, China's GDP grew about 8 percent a year and, thus, more than quadrupled in two decades[15]. Along with it, China received large FDI flows, year after year. Some of the reasons behind the success of Chinese experience are articulated in Box A.

Table 3 shows that there was an erratic pattern of flows into South Africa. The key reason was the faltering momentum of the government's privatisation programme, itself a victim of a shrunken telecom market. The transfer of assets from the South African state-owned Telkom to the private sector in 1997 was not followed by 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 1 shows how Brazil, India and South Africa have performed, compared with selected countries, in terms of the relationships between FDI and GDP and FDI and exports. India received FDI equal to below 0.5 percent of its GDP, South Africa received 0.7 percent, while Brazil received 5.8 percent of its GDP in FDI in 2000. The two ratios, the country's share of world FDI to the share of world GDP and to the share of world exports, are well below one for India and South Africa, demonstrating that they received much less FDI than their importance in the world economy. However, the ratios are high in Brazil, showing that they received a disproportionate share of world FDI. There are specific factors that influenced the decisions of foreign investors in Brazil in diverse sectors, but the dimensions and the dynamism of the local market appear to have been more general factors of attraction.

The increase in the flows of FDI in the 1990s in Brazil was reflected in the increase of the share of transnational corporations (TNCs) in the economy, which historically had always been high in Brazil and was increased even further. The transfer of the property of private and public limited companies to

foreign companies and the reduction of the relative importance of the remaining national capital companies are the other side of the process of internationalisation of the Brazilian economy.



Graph 1: Brazil, India, South Africa and Other Countries: Comparative FDI Indices

Source: IFD country reports.

FDI inflows to India have been much more modest than many other developing countries and has remained concentrated in a few sectors. The willingness of foreign investors to undertake investment in a host country would depend on several factors, apart from the investor-friendly nature of the policy regime, for instance, the attractiveness of the host country market and the global strategies of MNCs would also shape their investment location decisions. The current policies with regard to inward FDI flows can be argued to be very liberal in India. It was noted that FDI inflows to India in the 1990s has been associated with a significant incidence of cross-border merger and acquisition activity, leading to the shift of control over domestic enterprises to foreign firms[16].

South Africa's regulatory regime for FDI has undergone significant transformation and liberalisation since the country's successful transition to democratic governance in April 1994. SA's macroeconomic policy, the Growth, Employment and Redistribution (GEAR) strategy, adopted in 1996, is conceived within and oriented towards competitive global economy, with strong emphasis on fiscal discipline, investor confidence and macroeconomic stability. The Government is particularly keen to attract export-oriented FDI, thereby hoping to stimulate innovation and exports in local firms through technology and skill transfer. Between 1994 and 1999, FDI in SA experienced an investment expansion, due to an increase in M&As. The decline in FDI inflows to SA during 2000 is, therefore, partly explained by reduced M&A activity. It can be seen from Box B that the three countries have, now, quite a liberal policy regime.

Box B: Policy Regimes in Brazil, India and SA

POLICY REGIME	BRAZIL	INDIA	SOUTH AFRICA
Registration	Foreign investors need to register with the Brazilian central bank for new investments, reinvestments and remittances of profits to foreign countries. Declaratory certificates are given to the investors.	Foreign investors need to register with the Registrar of Companies. Policies are sector-specific and apply to domestic investors as well. There are two routes of approval: automatic approval given by the Reserve Bank of India and approval given by the Foreign Investment Promotion Board (FIPB).	Foreign investors need to seek approval under SA Reserve Bank's exchange control regulations. Investors need to appoint consultants/auditors/ legal advisors to register a company.
Trade policy	• Signed the Marrakesh Agreement. • Brazilian Industrial and Foreign Trade Policy (PICE) established an agenda of tariff reductions. This was followed until 1992, when a series of tariff reductions were anticipated. • Brazil is a member of MERCOSUR.	• Signed the Marrakesh Agreement. • Removal of Quantitative Restrictions on imports from April 2001 after India lost a dispute with the USA in WTO. • Lowering of trade barriers and liberalisation of foreign investment regime resulted in entry of foreign firms, and thereby, exposed the domestic firms to foreign competition. • India is a member of South Asian Preferential Trade Arrangement (SAFTA) which is non-functional. • Recently signed FTA with Nepal, Sri Lanka and Thailand.	• Signed the Marrakesh Agreement. • The Trade, Development and Co-operation Agreement (TDCA), signed with the EU in October 1999, provides for the establishment of a free trade area between the EU and SA. SA is also a member of Southern African Development Community (SADC).

POLICY REGIME	BRAZIL	INDIA	SOUTH AFRICA
Entry and Establishment	• Bilateral Investment Treaties (BITs) provide that investments will be admitted in accordance with the laws and regulations of the contracting parties. • Procedure has been simplified	• Bilateral Investment Treaties (BITs) provide that investments will be admitted in accordance with the laws and regulations of the contracting parties. • The Statement on Industrial Policy (Government of India, 1991) made FDI in 34 industries eligible for automatic approval up to a foreign equity participation level of 51 percent of the paid-up capital of the company.	• Bilateral Investment Treaties (BITs) provide that investments will be admitted in accordance with the laws and regulations of the contracting parties. • Foreign firms eligible for national investment incentives such as export incentive programmes, tax allowances and other trade regulations.
Investment facilitation institutions/ initiatives	• Established an institution called Invest Brazil to facilitate investment. • Investors need to get other statutory approvals, including environmental clearance, clearance for land acquisition and approvals from sectoral regulatory agencies. • M&A deals have to get the approval of competition authority (CA).	• Approval granted through FIPB – a single window facility. • Investors need to get other statutory approvals, including environmental clearance, clearance for land acquisition and approvals from sectoral regulatory agencies. • M&A deals need not get approval of competition authority at present. However, under the new competition law, they will come under the scrutiny of CA.	• Trade and Investment SA (TISA) is the official investment promotion agency. • Other agencies are: Department of Trade and Industry (DTI), Industrial Development Corporation of SA Limited (IDC), Small Business Development Corporation (SBDC) and International Investment Council (IIC). • Investors need to get other statutory approvals, including environmental clearance, clearance for land acquisition and approvals from sectoral regulatory agencies. • M&A deals have to get the approval of competition authority.

Source: IFD country reports, CUTS.

CHAPTER-4

Sectoral Distribution of FDI and Source Countries

As to the profile and destinations of FDI, an important tendency observed in the flow of FDI to both Brazil and India has been the growing loss of attraction of the manufacturing sector, in comparison with the service sector. In the case of Brazil, a great drop in the manufacturing sector's ability to attract FDI, in comparison with the service sector, has been seen. In 1989, although it was before the process of trade liberalisation and the economic crisis of the Collor Government, manufacturing was responsible for 71 percent of the stock of foreign capital invested in Brazil. With a reduced ability to attract investment inflows during the 1990s, this share was reduced to 55 percent in 1995. The more recent inflows of FDI confirm the trend towards the more than proportional growth of investment to the tertiary sector, in relation to the secondary sector, with the former attracting 59.6 percent of the FDI and the latter 33.3 percent, in the year 2001 (see Table 4).

In India, until the early 1990s, FDI was heavily concentrated in the manufacturing sector. This appears to be due to a bias in favour of import substitution (IS) industrialisation, which may have encouraged tariff-jumping type investment to capture protected domestic market. However, in the period 1991-2001, the Indian tertiary sector attracted maximum FDI inflows among the three major sectors comprising the economy. In SA, while the tertiary sector attracted the majority of FDI inflows in the year 2000, it is followed by the primary sector (28.9 percent) and then by the secondary sector (26.4 percent) (see Table 4).

Table 4: Ranking of Sectors Attracting FDI[17]

RANK	BRAZIL (2001)	INDIA (1991-2001)	SOUTH AFRICA (2000)
1	Tertiary (59.6%)	Tertiary (56.32 %)	Tertiary (45.5%)
2	Secondary (33.3%)	Secondary (42.78%)	Primary (28.9%)
3	Primary (7.1%)	Primary (0.9%)	Secondary (26.4%)

Note: FDI as a percentage of total FDI approvals.

With regard to the share of source countries in FDI inflows, USA remained the largest investor in all the three countries (see Table 5). Other traditional investors in the Brazilian economy, such as Germany, Switzerland and Japan lost their share in the flows. On the other hand, countries like Spain, Netherlands and Portugal, which were strongly involved in the privatisation, had their share increased. In India and SA, some of the major investors were Japan, Germany, UK, Australia, South Korea and Switzerland.

Table 5: Top Three Investing Countries

RANK	BRAZIL	INDIA	SOUTH AFRICA
1	USA	USA	USA
2	Spain	Japan	UK
3	The Netherlands	Germany	Australia

CHAPTER-5

Investment Policy Audit

Foreign investment regulation which existed in Brazil until the end of the 1980s enjoyed a great deal of success in attracting and directing foreign capital towards the manufacturing sector. The upturn of FDI in the Brazilian economy in the '90s was basically the result of the recuperation and subsequent expansion of the internal market. There is no doubt that the structural changes carried out by liberalisation and privatisation played an important role, mainly in the services sector. These changes removed obstacles to entry of foreign investors and, in this sense, constituted a necessary condition, albeit insufficient. The main factors of attraction were the dimensions and dynamism of the internal market, in some cases reinforced by MERCOSUR. The Brazilian privatisation programme is crucial to understand the dynamics of FDI after 1995 (see Box C). In 1998, one in each five dollars invested by foreigners in Brazil was absorbed by privatisation. In 1999, with the privatisation of telecom companies, the ratio grew to 28 percent of FDI, reaching US$8.7bn.

Box C: Privatisation Policy in Brazil
The inflows of FDI to the privatisation programme were insignificant in its initial years. The amount increased fast in the following years, especially when public service companies were sold. The privatisation programme helps explain the preponderance of the service sector over the industry sector, as a share of FDI in the 90s. Only in the electricity sector FDI reached US$3.9bn before 1999. At the state level, the privatisation of gas, electricity, water supply and banks reached 47.5 percent of the total US$24.5bn collected in the process. Nevertheless, the bulk of FDI in the service sector was directed to the privatisation of telecommunication companies and financial institutions. Of the total amount of US$71.2bn, US$30.9bn were invested by foreign companies between 1991 and 1999. North American investors were responsible for 34.2 percent of the total FDI in the privatisation programme

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in the same period, followed by the Spanish (26.2 percent – mainly in the telecommunication and bank sectors) and the Portuguese (15.8 percent). FDI inflows due to privatisation were a significant portion of FDI inflows in form of M&As in Brazil. After 1996, when foreign investors started to participate in the privatisation programme, the ratio between the FDI flows to M&As and the total FDI flows grew from 44.5 percent to 85.7 percent in 1998. These impressive numbers show that the privatisation programme played a key role in the capacity to attract FDI to the country.

Source: Investment Policy in Brazil- Performance and Perceptions.

From the beginning of 1990s, Brazilian regulation underwent important changes, in terms of the removal of mechanisms which were obstacles to outward remittances and the withdrawal of capital (the elimination of limits for remittances, of supplementary tax, reduction of income tax on remittances, of restrictions on transference of technology contracts etc). These changes were introduced in parallel with liberalisation and deregulation of the financial market, which aimed to stimulate the portfolio investment of foreign investors. The Constitutional revision of 1993 and the amendments approved from 1995 onwards progressively removed the restrictions on foreign capital. The distinction between Brazilian businesses owned by domestic capital and those by foreign capital was eliminated.

In India, the 'first generation' of reforms, brought about in the early 1990s after the balance of payments crisis and the IMF rescue-package of 1991, defined the relevant macro policy context. These reforms included the liberalisation of industrial policy, which had consisted of an intricate web of licences 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 the balance of payments situation to a comfortable level 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, which 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.

India adopted a disinvestment policy in 1991 to restructure state-run units, bring down government equity in "non-strategic" state-run units to 26 percent

or less and hold majority share in "strategic" state-run units. Dis-investment entailed sale of shares and transfer of management of state-run units to strategic investors including other state-run units and off-loading of shares in the market for a wider public participation including participation by the employees of the state-run units. The receipt from privatisation and dis-investment was to be used for meeting expenditure in social sectors, restructuring of state-run units and retiring public debt. Contrary to expectations, the disinvestment exercise was not a success.

The current policies with regard to inward FDI flows into India can be argued to be very liberal. Post-entry, foreign firms are afforded national treatment in general, while there are some pre-investment scrutiny requirements, depending on the industry in which the investment is being made. The differential treatment is limited to a few entry rules spelling out the proportion of equity that the foreign firm can hold in an Indian (registered) company or business. There are a few banned sectors (like lotteries and gaming and legal services) and some sectors with limits on foreign equity proportion. For example, foreign equity is limited up to 74 percent in sectors like oil marketing and up to 26 percent in production of defence equipment. Over the years, sectoral caps on foreign equity participation have been relaxed, for instance, with the introduction of a new automobile policy, and 100 percent equity participation has been allowed in the automobile and components industry. Till now, there has not been a single case of back-tracking, i.e., a reduction in the limit of foreign equity participation for any industry.

The investment climate in India is far less than satisfactory, as reflected by the huge difference between the approved and actual flows of FDI. To identify factors inhibiting higher FDI flows, the Government of India constituted in August 2001 a Steering Group on Foreign Direct Investment under the Chairmanship of N. K. Singh, Member of the Planning Commission, Government of India (also known as the N. K. Singh Committee Report). The Group has recently submitted its reports with recommendation of accelerating the rate of growth of FDI flows. According to the report, "most of the problems for investors arise because of domestic policy, rules and procedures and not the FDI policy per se or its rules and procedures" (see Box D).

Box D: Stylised Facts on FDI Procedures and Delay in India
Several consultants have made presentations to the Steering Group on the issue of delays in obtaining FDI clearances. The summary of their observations is as follows: • According to Boston Consulting Group, investors find it frustrating to navigate through the tangles of bureaucratic controls and procedures. • McKinsey (2001) found that the time taken for application/bidding/ approval of FDI projects was too long. Multiple approvals, excessive delays and long lead time of up to six months for licences for duty free exports, lead to loss of investors' confidence, despite promises of a considerable market size. • According to a CII study, a typical power project requires 43 Central Government clearances and 57 provincial government (including local administration) ones. Similarly, the number of clearances for a typical mining project is 37 at the Central and 47 at the provincial government level.
Source: Report of the Steering Group on FDI, 2001.

The SA Government actively encourages direct investment by non-resident persons and companies. There are, generally, no restrictions on the type or extent of investment available to foreign investors in the SA economy. Restrictions would usually relate to a particular industry and be applicable to both residents and non-residents. Very few restrictions apply only to foreign companies. In the banking sector, for example, a foreign bank establishing a branch in SA may be required to employ a certain minimum number of local residents in order to obtain a banking licence and may be obliged to maintain a minimum capital base of at least US$1,58,480. Restrictions also exist regarding the ownership of immovable property by foreign companies (www.isa.org.za). The Government treats foreign investment essentially the same way as domestic investment. Foreign firms are eligible for various national investment incentives such as export incentive programmes, tax allowances and other trade regulations.

In SA, the key policy document is the GEAR (Growth Employment and Redistribution) strategy. It 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 percent to 26 percent to

achieve target growth rates requiring capital inflows equivalent to 4 percent of the GDP. This is expected to crowd in domestic investment and contribute to a rise in exports. Despite the government's efforts to promote and market SA as an investment destination, the current FDI rates are low. SA is also performing poorly, compared to other emerging markets such as Brazil, China, Mexico and Poland, in attracting FDI inflows (cf. UNCTAD, 2001). The discourse about why SA is failing to attract FDI is a highly contentious debate and is very much based on perceptions, particularly among business, of conditions in SA. These perceptions may be informed or not, but are nevertheless salient as explanatory variables to account for SA's paltry FDI flows. Box E lists out factors that have been said to be retarding investment inflows into SA.

South Africa is also an important source of FDI in the Southern African region and the African continent. The share of SA investment in total FDI to SADC is about 47 percent of all deals made in the region.[18] In 2001, SA invested R14,969 mn (USD2268mn)[19] in SADC, mainly in Mozambique and the Democratic Republic of Congo (DRC), which increased to R68,596 mn (USD10,276mn)[20] in 2002. A study by Liquid Africa[21] says that SA is the largest source of FDI for Africa. The sectors, in which the SA firms invested were mainly mining and construction, financial services, telecommunication, consumer goods, health care, the media and retail. This increase in SA FDI is attributed to a range of factors such as: the liberalisation of exchange control regulations, which now permits SA to invest upto R2 bn per project in Africa, compared with R500 mn in any other region; greater risk taking in Africa by the Development Bank of Southern Africa (DBSA) and the Industrial Development Corporation (IDC); and increased exports by SA to the region. The other factors were saturation of domestic investment, advantage enjoyed by SA firms over investors from outside Africa since they have a better understanding of regional industrial trends and policy environments, growth of new investment opportunities in the SADC free trade area and privatisation etc.

However, latest trends show that SA firms are dominating and crowding out certain industries in some southern African countries. This pattern follows the one laid down by the traditional 'core-periphery' principle, since SA continues to supply with manufactured goods and inputs through trade and investment to southern Africa and imports mostly raw materials or low value-added goods, from the region. It is now thought that a regional investment framework to regulate and channelise FDI according to regional development priorities would be able to correct the trend highlighted above. In fact the SADC has engaged itself in developing a Protocol on Finance and Investment through a bottom-up process of Memorandums of Understanding (MOUs) at present.

Box E: Why is SA not Attracting FDI?

- **Small market size of SA and SADC:** SA's market size (GDP as well as population) is considered too small to attract FDI, especially market-seeking FDI. The evidence in developing countries suggests that FDI inflows have taken place to large and fast growing markets. The SADC market of 190 million people is also considered too small and indigent for profitable investment. This explanation would seem to only account for market-seeking FDI.
- **Low economic growth:** SA's low economic growth rate (2.2 percent in 2001, expected to rise to 2.3 percent this year) does not encourage investment; linked to this are low per capita incomes. The link between economic growth and FDI is ambiguous. It is argued that FDI, once attracted, will stimulate economic growth. However, SA actually needs a significant amount of economic growth to attract FDI in the first place. Evidence in other developing countries (such as China, Malaysia, Singapore and Argentina) has shown that a sustainable, long-term growth pattern attracts FDI and it, in turn, leads to higher economic growth. Economic growth in SA requires sound market-friendly economic management, a focus on supply-side measures (skills, education, etc.,) and increased domestic fixed investment by both the private and public sectors.
- **High-risk premium:** This relates to risk concerns over property rights, government policy and politically volatile events within the region that have a potential 'spillover' effect (e.g., Zimbabwe). Africa, and particularly Southern Africa, is perceived to be high-risk destination for investment (although the civil war in Angola did not prevent investment in that country's mineral-rich enclaves; SA has played second fiddle to Angola in attracting FDI). SA, however, has a well-established intellectual property rights regime and the Government is committed to stable property relations, the rule of law and the maintenance of domestic and regional order.
- **Perceptions relating to labour (organised):** SA's labour market is perceived to be inflexible and over-regulated. The difficulty of laying off workers and exceptions (such as complying with employment equity legislation) are seen by global companies as a serious obstacle to investment. Although this is the perception of SA, this is, in reality, not necessarily the case. In SA, one out of seven workers has been fired over the last six years. There is a whole lack of understanding of the new labour regime, due to inadequate and inappropriate training. It is

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easy to fire workers if they are incompetent; employers, however, need to follow a strict bureaucratic procedure (which in itself is a disincentive).

- **Inappropriate skills level of labour force:** SA's bureaucratic and complex immigration policy for skilled persons aggravates this dearth of skilled human capital.
- **Lack of correct, positive information (DTI incentives and comparative advantages).**
- **Regulatory uncertainty:** This is particularly the case in the *telecommunication* (after the introduction of a second network operator), *electricity* (the possibilities for private power stations to enter the market and compete with Eskom) and *transport sectors.*
- **Domestic business confidence:** The low level of domestic savings and domestic investment in the SA economy is taken to be an ill omen. Changing of their primary listing from the Johannesburg Stock Exchange (JSE) to the London Stock Exchange (LSE) by SA's five largest listed companies – i.e., Billiton (mining and metals), Old Mutual (insurance), Anglo-American Corporation (mining), SA Breweries (SAB) and Dimension Data – has made most foreign investors circumspect about investing in SA. The question asked is *if South Africans do not invest in the SA economy, why should we as non-nationals?* This argument does not take into account that these LSE companies have outgrown the SA market and need to establish a global presence. An LSE listing provides access to more and cheaper capital to finance expansion and the possibility of being listed on the FTSE 100, a favourite with index tracker funds, thus boosting levels of investment for the company (Business Map, "Behind the fuss about the London listings").
- **Falling exchange rate:** Returns on investment have been depreciating since SA's rand has generally been depreciating since the mid-1990s. The rand's rapid depreciation in December 2001 meant that for existing foreign investors, a 40-percent profit margin in 2001 would have shrunk to 3 percent after the Rand's fall. Although a constantly declining currency is a disincentive to investors, SA's exports are cheaper in dollar terms and, therefore, more competitive.

Source: Investment Policy in South Africa – Performance and Perceptions.

CHAPTER-6

Competition for FDI and the Convergence of Investment Policies

A growing consensus holds that the potential benefits of FDI outweigh its potential costs. This has heightened competition to attract FDI. Following the changes in Central and Eastern Europe, competition for FDI heightened.[22] The regulatory framework for FDI is a tool being used in this competition. With FDI policies converging across the countries, the remaining differences in the policy regimes exercise less and less influence on the locational decision of TNCs. Instead, the appeal of any host country to potential investors is determined by other factors such as investment incentives and promotion schemes, good infrastructure and support services and other policies such as privatisation policy, trade policy (tariffs and non-tariff barriers) and regional/industrial policies (see Table 1). In an increasingly integrated world economy, the relative attractions of developing versus developed countries are of greater importance. For many developing countries, this situation throws up stiff competition. It means that their governments should play an active role in improving their economies as locations for FDI. Finding appropriate proactive measures to attract FDI in an emerging international production system is one of the key policy challenges facing many developing countries.

In this context, competition among states (to attract FDI) in a federal set up can be examined. Just as nations compete among themselves for FDI, there is also the possibility that states/provinces would compete amongst each other for FDI in large emerging countries such as those under consideration in this study. For instance, such a competition had been observed in India in the 1990s. As per a study done at the National Council of Applied Economic Research (NCAER) on the automobile and power sectors, competition amongst the states to attract investment is akin to a prisoners dilemma type game. The problem is treated as a game between different states, whereby it is individually rational for the states to offer incentives, but it is collectively rational for them to cease offering incentives. However, to offer incentives for attracting FDI is the dominant strategy for each of the states, irrespective of the strategy adopted by the others, and, hence, the lack of co-operation in the game.

CHAPTER-7

Civil Society Perceptions

Under the IFD project, a national survey on civil society perceptions was conducted in the three countries. The aim of the survey was to gauge the perceptions of civil society respondents on the positive and negative aspects of FDI, the relationship between FDI and domestic investment, and the measures governments should adopt to facilitate FDI. The number of respondents to the survey in Brazil was 11, India 38 and SA 26. The analyses of questionnaires answered by civil society representatives in all three countries reveal that, in general, there is a perception among the majority of the respondents that FDI plays a key role in developing the economy.

In Brazil and India, around 80 percent respondents believe that FDI has been contributing positively over the last ten years. In South Africa, almost 90 percent respondents believe that FDI has contributed to national development objectives over the past 2-5 years. Some of the negative perceptions of the civil society are that FDI brings in environmentally harmful technologies and reduces the profitable opportunities available to domestic investors (see Table 6). Civil society is also of the opinion that foreign investors do not care about their impact on the society.

However, most of the respondents in the countries agree that FDI brings in valuable new technologies as well as management techniques, improves the access to world markets and increases the competitiveness of the economy.

However, the perception regarding the sectoral impact of FDI differs from country to country. In Brazil, telecommunication services, finance/banking system and the automobile sectors stood to gain, while in India, it was information technology (IT) sector, power, automobiles, chemical and engineering goods. In South Africa, the automobile industry is believed to have had the greatest impact on the local economy and society, followed by mining, IT and telecom, metal products and financial services.

Table 6: Civil Society Perception of FDI			
	Brazil	**India**	**South Africa**
FDI brings in valuable new technologies	Agree	Agree	Agree
FDI makes up for insufficient domestic investment	Agree	Agree	Agree
FDI improves the competitiveness of the national economy	Agree	Agree	Agree
FDI increases access to world markets	Agree	Agree	Agree
Foreign investors are only interested in getting access to domestic markets	Agree	Agree	Disagree
FDI reduces the profitable opportunities available to domestic investors	Inconclusive	Disagree	Disagree
FDI brings in environmentally harmful technologies	Inconclusive	Agree	Inconclusive
FDI results out of unfair advantages of multinational firms	Inconclusive	Inconclusive	Disagree
FDI brings in valuable new management techniques	Agree	Agree	Agree
FDI is a valuable source of foreign capital	Agree	Agree	Agree
FDI helps enhance exports	Agree	Agree	Agree
FDI helps reduce imports	Inconclusive	Inconclusive	Agree
Foreign investors do not care about the impact of their investments on civil society	Agree	Agree	Disagree

Agree: More than 50 percent of respondents ‘agree’.
Disagree: More than 50 percent of respondents ‘disagree’.
Inconclusive: No inferences could be made from the data.

CHAPTER-8

Experience of Automobile Industry in the Emerging Economies

Under the IFD project, the project countries studied investment policies, performance and perceptions in selected sectors. The automobile industry is one such sector. The industry has experienced major changes in policies and trends in 1990s. The automobile industry in Brazil, India and South Africa was the object of various incentive policies throughout the 1990s. This section reports the findings of case studies conducted in these countries, outlining the experience of the automobile industry in these emerging economies.

Prior to the introduction of reforms in the automobile industry in Brazil, India and South Africa, the growth in the sector was primarily due to local content requirements and high tariff on imports. This led to lower productivity in the Brazilian automobile sector and high cost of vehicles, coupled with low volume of production in South Africa. In India, there were only three motor-car manufacturers until 1982. However, the decade of the 90s witnessed widespread reforms in the automobile industry in all the three countries under consideration. In 1993, the Indian auto sector was de-licensed and in 1995 the Motor Industry Development Programme (MIDP) was launched in South Africa. In Brazil, a process of productive restructuring has been launched recently to make the industry more efficient and competitive.

The annual average of investment of car-makers in Brazil more than doubled, from US$500mn in the 1980s to US$1.3bn in the first-half of the 1990s, when investment in the sector took place on account of rationalisation and modernisation[23]. In the second-half of the decade, characterised more by investments on creation and expansion of capacity, the annual average volume increased again, reaching a level higher than US$2bn. In the 1990s, approximately US$16.5bn were invested in the car industry.

With an investment of US$10bn, the turnover was US$11.9bn in the automotive sector in India during 1999-2000. It employs 4,50,000 people directly and 10 million people indirectly and is now inhabited by global majors in keen contention. In India, since the de-licensing, the automobile industry, including

auto component sector, has shown great advances. The contribution of the automotive industry to the GDP has risen from 2.77 percent of the GDP in 1992-93 to the current value of 4 percent of the GDP.

In SA, the auto industry is a major contributor to its GDP. In 2000, at current prices, GDP was US$138.45bn – up from US$126.07bn in 1999 – and the industry's overall contribution was 5.4 percent. Between 1994 and 1999, the motor and components sector attracted FDI to the value of around US$903.33mn. In 2000, this sector ranked second, in terms of investment inflows for that year, partly as a result of consolidation and reinvestment by car manufacturers and catalytic converter facilities.

The automobile industry in Brazil has been experiencing high investment, especially in the installation of auto manufacturing plants, with a significant impact on many other related segments. Recent investment in the construction of auto plants and auto parts plants are expected to lead to a new configuration for automotive production, especially in regional terms. In view of the importance of the auto parts sector and the need for a local supplier base to make the desired level of growth possible, the Economic and Social Development National Bank (BNDES) has sought to strengthen its efforts in the sector. In 1996, it created a programme to support the auto parts supplier network, the objective of which was to increase the supply of parts and components in Brazil and to foster wide participation of local companies in the market by expanding their capabilities.[24] The programme, in addition to the sector growth requirements, led to a significant increase in BNDES disbursements to the sector. The total amount of transactions at the end of 1999, including signed contracts, approved contracts, projects under analysis and proposals approved, was in excess of US$700mn and comprised 34 companies.

Although the automobile industry in India is six decades old, until 1982, only three manufacturers existed in the motor-car sector – all in the private sector. In 1982, Maruti Udyog Ltd. (MUL) came up as a government initiative, in collaboration with Suzuki of Japan, to establish volume production of contemporary models. With the launching of the economic reforms in 1991 and the lifting of licensing in the auto sector in 1993, 17 new ventures have come up, of which 16 are for manufacturing of cars and 1 is for that of trucks. India's automotive component industry manufactures the entire range of parts required by the domestic automobile industry and currently employs about 250,000 persons. Auto component manufacturers supply to two kinds of buyers – original equipment manufacturers (OEM) and the replacement market. The replacement market is characterised by the presence of several small-scale

suppliers who score over the organised players in terms of excise duty exemptions and lower overheads. The demand from the OEM market, on the other hand, is dependent on the demand for new vehicles. Automotive components manufactured in India are of top quality and are used as original components for vehicles which were manufactured by such top international companies as General Motors, Mercedes and Daewoo, among others.

8.8 The SA motor industry is undergoing a process of radical change. As part of its plan to attract manufacturing investment, the Government replaced its previous strategy to develop a local motor vehicle manufacturing industry with the 7-year MIDP in 1995. Previous strategies to develop the domestic industry were premised on local content requirements and high tariffs on imports (India and Brazil used similar protective regimes to develop their industries). Although this policy was effective in leading to the establishment of a significant assembly industry, encouraged into 'partnership' with a diversified domestic component sector, most producers were not internationally competitive. Most locally assembled vehicles were sold at a premium, compared to world prices.

The MIDP abolished all the local content requirements of the previous programme, lowered tariffs on imported vehicles and components, established a duty-free allowance (27 percent of the wholesale value of a finished vehicle) for original component and equipment imports, allowed for the offsetting of import duties on components and vehicles through import rebate credits earned from exports and established a higher duty-free allowance for low cost vehicles. These incentives were partly responsible for attracting efficiency-seeking investment such as the motor manufacturing company BMW to SA, where it has invested in an export assembly plant. Further, the Automotive Industry Export Council (AIEC) was established in 1999 to co-ordinate and address matters of interest to SA producers involved in the export of vehicles and automotive components. The Gauteng Provincial Government has launched a US$158.7mn automotive manufacturing cluster which aims to attract the automotive component makers as neighbours of the four major auto groups – BMW, Fiat, Ford and Nissan – bringing in major savings in transportation and logistical costs.

CHAPTER-9

Recommendations and Conclusion

Nowadays, all emerging economies are competing hard to attract FDI. Policy efforts to attract FDI take place, in many cases, not only at national levels but also at various sub-national levels. Typically, these efforts focus on the following areas:

- *Improving the regulatory framework for FDI.* Important in this respect is also the fact that countries seek to improve their capabilities to face the challenges of a more interdependent and competitive world.[25] Efforts to ensure greater policy coherence, especially between FDI and trade policies, are part of these efforts to obtain greater systemic competitiveness, as are, of course, the more basic efforts to ensure macroeconomic, social and political stability and predictability.
- *Facilitating business.* Beyond the liberalisation of regulatory frameworks (a more passive policy approach), more and more countries also give attention to proactive policies to attract FDI. Most countries have established investment promotion agencies[26] whose purpose is precisely to facilitate FDI and look after foreign affiliates once they are established (by providing a range of after-investment services). In addition, many countries are engaged in a continuing process of regulatory reforms, in the framework of which they seek to reduce "hassle costs" of doing business, through more efficient administration. In this context, we can refer to India, where bureaucratic and red tape levels are high. There are delays at each stage of project implementation. However, this is not the case with Brazil, which has a better regulatory system.
- *Improving the economic determinants.* While the preceding sets of factors are important in terms of creating an appropriate enabling framework for FDI and, more generally, a good investment climate, in the end it is the economic determinants that are most important for the locational decisions of TNCs. With markets becoming more open and technology and competitive pressures fostering the formation of integrated international production systems, the skill level and the adaptability of human resources, the quality of the physical infrastructure and various assets created (including innovatory capacity) are becoming more important, as is the existence of a vibrant domestic entrepreneurial sector and, in particular, the capacity of local suppliers to provide world standard inputs. Governments in emerging

economies should pay attention to upgrading the determinants of locational decisions, be they decisions taken by foreign or domestic firms.

Governments in emerging economies increasingly seek to create an environment in which firms, both domestic and foreign, can prosper. The ultimate objective of governments in attracting FDI is, of course, to promote growth, development and structural change. FDI can play a role in this respect, but there is no simple and single description of what this role should be. To attract FDI, sectoral caps should be reduced to a minimum and entry barriers eliminated. An enabling environment should be created for foreign investment in the infrastructure sectors by establishing a good transparent regulatory framework.

The governments in Brazil, India and South Africa have been taking steps to strengthen the environmental, labour, sectoral and Intellectual Property Right regulations.

In economies like South Africa, with existing socio-economic inequalities, there should be programmes to develop backward regions and provide support for a vibrant co-operative movement, land reform and small micro enterprises. The focus should be on increased production to meet the basic needs for the majority.

In economies like Brazil that already host a large stock of FDI, it is imperative that the government should formulate policy instruments to strengthen spillovers from foreign firms to domestic firms. Co-operation among locally-owned and foreign firms, aiming at improving productivity and technological capabilities, have an important role to play in creating welfare improvements and winning public opinion.

In India, the performance under the government's privatisation programme has been disappointing. Almost half of India's productive assets remain under the state control and large proportions of these are key infrastructure assets. Many of the public sector companies are, generally, less efficient than their private counterparts. In this regard, India can learn lessons from Brazil, where the privatisation programme has been generally successful.

In all the three countries, there are significant groups in the public sector and civil society that oppose further economic reforms. If the policies advocated in this paper are to be effectively carried out, the governments will have to spend time on winning over these groups and creating a strong domestic opinion in favour of reforms. Providing balanced information to civil society and encouraging an open national debate on investment issues would help create the necessary pressure for beneficial reform.

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ENDNOTES

1 UNCTAD IX, 1996, "A Partnership for Growth and Development", paragraph 36.

2 UNCTAD, 1999, *Foreign Direct Investment and Development*, UNCTAD Series on issues in international investment agreements.

3 The cost and benefits of FDI are spelled out in some detail in Dunning J.H. "Re-evaluating the Benefits of FDI" [Transnational Corporation 3, Feb 1994, pp:23-52].

4 See United Nations, 2000*, "World Investment Report."* In the literature, a third mode of entry, the concept of *brownfield investment* can also be found. It denotes a hybrid situation in which the foreign investor acquires a firm but almost completely replaces plant and equipment (Meyer and Estrin, 1998).

5 Imad A Moosa, 2002, *Foreign Direct Investment: Theory, Evidence and Practice*.

6 Export-increasing FDI, which increases the export of final products of the host country, is not widely prevalent.

7 Direct investment comprises not only the initial transaction establishing the relationship between the investor and the enterprise but also all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated (IMF, *Balance of Payments*, fifth edition, 1993, p. 86.).

8 S Vikraman, "*Change in FII Portfolio Flow Classification Likely",* Hindu Business Line August 2, 2002.

9 See website www.isa.org.za.

10 Investment Policy in Brazil – Performance and Perceptions, CUTS, 2003.

11 Same as 10.

12 CUTS, 2002, *Foreign Direct Investment in India and South Africa: A Comparison of Performance and Policy*, CUTS-CITEE Briefing Paper.

13 Same as 10.

14 Joseph Stiglitz, *"From Miracle to Crisis to Recovery: Lessons from Four Decades of East Asian Experience"*, in Joseph Stiglitz and Shahid Yusuf (Eds.), 2001, *"Rethinking the East Asian Miracle*", Oxford University Press.

15 Yingyi Qian, *"Government Control in Corporate Governance as a Transitional Institution: Lessons from China",* in Joseph Stiglitz and Shahid Yusuf (Eds.), 2001, *"Rethinking the East Asian Miracle*", Oxford University Press.

16 Investment Policy in India – Performance and Perceptions, CUTS, 2003.

17 At a more dis-aggregated level, the automobile sector in Brazil has attracted the maximum investment, followed closely by the chemical sector and the food and beverage sector. In India, the IT sector had the highest share, with engineering and services following closely. In SA, the sectors that have attracted the most investment between 1994-99 are transport and telecommunication sectors (due to the privatisation of Telkom in 1997), energy and oil sectors, food and beverages and tobacco sectors.

18 According to a 1999 count by the University of Cape Town-based Development Policy Research Unit of BusinessMap FDI data.

19 Based on the exchange rate prevailing on 1.1.2004; www.xe.com

20 *Ibid*

21 *Business Day*, 3 July 2003, p. 2

22 UNCTAD, World Investment Report 1993, Chapter IX.

23 Same as 10.

24 Angela Maria Medeiros M. Santos and Caio Marcio Avila Pinhao, *"Investments in the Automotive Industry: BNDES Actions"*.

25 Dunning, 1992, 1993b.

26 The World Association of Investment Promotion Agencies (supported by UNCTAD, UNIDO and MIGA) has some 100 members.