

**"SHOULD SOUTH AFRICA HAVE
AN FDI POLICY?":
A critical analysis of South Africa's
current policy stance.**

Richard Cohen

A Dissertation Submitted to the Faculty of Commerce
University of the Witwatersrand
for the Degree of Master of Commerce

Johannesburg 1998

ABSTRACT

The purpose of this paper is to provide a critical assessment of the Foreign Direct Investment (FDI) policy stance in South Africa. We analyse whether investment incentives will be effective in increasing FDI inflows and look at the importance of the behaviour of transnational corporations (TNCs) in determining the impact of FDI on the host. This analysis allows us to determine the appropriate objective of FDI policy, namely channelling TNC behaviour such that they generate the desired benefits for the host. This raises the question of how such behaviour may be channelled in practice.

Using the framework of information economics, we identify the nature of the difficulties with which policy makers must deal in designing behavioural incentives. Although this does not lead us directly to policy prescriptions, when augmented with practical considerations, it provides us with a basis for analysing whether FDI policy (as distinct from industrial policy) is called for. By isolating one instance in which a differentiated approach would be likely to increase the efficacy of policy, we show that there is good reason to suspect that the absence of a distinct FDI policy in South Africa may be sub-optimal.

DECLARATION

I declare that this dissertation is my own work.

It is being submitted for the degree of Master of Commerce at the University of the Witwatersrand. It has not been submitted before for any degree or examination in any other university.

Richard Cohen

1st January, 1998

To my parents,
for their empathy and encouragement.

CONTENTS

PREFATORY NOTE	vi
1. INTRODUCTION	1
2. THE LOCATIONAL DECISIONS OF TNCs	5
3. THE IMPACT OF TNC BEHAVIOUR ON THE BENEFITS OF FDI	9
3.1 Benefits of FDI	10
3.2 Conclusion	17
4. A THEORETICAL APPROACH TO FDI POLICY	19
4.1 Information economics and moral hazard	19
4.2 Conflict of interest	20
4.3 Information asymmetry and the difficulties of monitoring and enforcement	22
4.4 Policies in practice	26
5. SOUTH AFRICAN POLICY APPLICATION	30
5.1 FDI policy in South Africa	30
5.2 The three components of the South African tax holiday scheme	31
5.3 The value of tax holidays to recipient TNCs	32
5.4 Inefficiencies caused by the undifferentiated nature of the South African tax holiday scheme	35
6. SUMMARY AND CONCLUSION	40
BIBLIOGRAPHY	43

PREFATORY NOTE

For several decades, the Transnational Corporation has been the source of much controversy and lively debate. By virtue of both the potential for Foreign Direct Investment to contribute significantly to the economic welfare of its recipient country, and the important role that FDI policy is able to play in determining such contribution, the topic of FDI policy is indeed an important one. This paper makes a contribution to the FDI policy debate by defining the appropriate objectives of such policy. By bringing the highly stylised theory of information economics into a field where it has never been applied before, we gain a clear understanding of the nature of the FDI policy problem. This, in combination with certain practical considerations, enables us to formulate certain criteria by which FDI policy may be assessed. By analysing the South African tax holiday scheme, we highlight an instance where the present South African policy stance is sub-optimal.

This paper is not empirical in nature and does not intend to suggest a set of policies that will maximise the benefits of FDI to hosts in general or South Africa in particular. It is hoped that, by indicating the likelihood that the present policy stance can be improved upon, it will serve as the harbinger of future research efforts. The latter will need to include the empirical studies that will be necessary to specify the necessary policy changes.

I am indebted to Ha-Joon Chang, Andrew Donaldson, Johann Fedderke, Evan Gilbert, Fabian Goodie, Mario Scerri, Charles Simkins, Graeme Tucker and Harry Zarenda without whose valuable advice, this paper would not have been possible.

The generous sponsorship of the Centre For Science Development is gratefully acknowledged.

Richard Cohen

CHAPTER 1

INTRODUCTION

"[It is] *beyond dispute* that the spread of multinational business ranks with the development of the steam engine, electric power and the automobile as *one of the major events of modern economic history*."¹ This is a rather extreme example of the way in which Foreign Direct Investment (FDI) is often believed to benefit the recipient thereof. The logical consequence of such sentiment has been the design of policies to increase the inflow of FDI.² This paper begins by showing that there are reasons to doubt both the premise and efficacy of such policies.

We argue that the focus of FDI policy should be on managing the impact of FDI once it has occurred rather than simply increasing the quantity thereof. We consider both the nature of the problem that such policies need to solve, and the practical difficulties that will be encountered in their implementation. Having established the form that these policies take in reality, we turn to the South African policy stance toward FDI. On the basis of the framework established, we discover that there are a number of reasons to suspect that the efficacy of South African policy could be improved insofar as it relates to FDI.

Although South Africa has policies in place that are designed to manage the impact of investment, there is no distinct FDI policy. By isolating South Africa's tax holiday scheme, in which (like a variety of other industrial policies) no distinction is made between foreign and domestic investors, we illustrate that systematic differences exist between domestic and foreign investors in the efficacy of the policy. If such efficacy could be increased by differentiating between foreign and local investors, there are grounds to criticise South Africa's decision to subsume FDI policy under industrial policy.

Our choice of tax holiday schemes is a consequence of such schemes being well-documented foreign investment incentives.³ Their efficacy is therefore an important issue in its own right. Moreover, this policy measure is one with a number of respects in which

¹ U.S. Tariff Commission, 1973.

² e.g. See Dunning (1993), pg. 176.

³ e.g. See Zainuddin (1993), Halleiner (1999) and Dunning (1993).

the impact thereof differs between foreign and domestic investors. Our focus on FDI policy, as distinct from general industrial policy, derives from our proposition that there may be gains from treating Transnational Corporations (TNCs)⁴ differently to domestic firms.⁵

By focusing on FDI policy, we are not precluding the possibility that much of our analysis will also be germane to industrial policies. Nor are we precluding the possibility that some FDI policies should be applied in the same form to domestic investors. The overlap between FDI policy and industrial policy may thus be substantial. We will, however, argue that in those cases where we are able to identify systematic differences between the nature, impact or behaviour of foreign and local firms, a differentiated policy approach is called for. Consequently, FDI policy deserves separate analysis, and applying uniform policies in the absence of an attempt to identify such differences denies the government the possibility of increasing the efficacy of its policy measures.

The following is a brief chapter outline.

In order to assess the South African tax holiday scheme as an FDI policy, a number of issues will require analysis. We begin by analysing the extent to which the South African tax holiday scheme is capable of increasing the general attractiveness of South Africa as a host to TNCs. This is done in chapter 2 by considering an array of factors that influence the TNC's choice of location. We argue that investment incentives as a whole are weak determinants of the TNC's choice of location relative to factors that fall outside of the scope of FDI policy. Consequently, we argue that increasing the quantity of FDI inflows is not the appropriate focus of FDI policy.

In chapter 3, we argue that the objective of FDI policy should rather be to maximise the benefits derived from the presence of TNCs once they have invested. We arrive at this

⁴ The definitional question of precisely what constitutes a transnational corporation is potentially a slippery issue. We shall not become embroiled in the debate and settle on a workable definition. This approach is supported by authors such as Cowling and Sugden (1987) who point out that "... the aim in defining a transnational is to isolate a concept which can be used to explore important issues from a theoretical standpoint." Cowling and Sugden have defined Transnational Corporations thus: "A transnational is the means of co-ordinating production from one centre of strategic decision making when this co-ordination takes a firm across national boundaries". This definition will prove adequate for our purposes here. Throughout this paper, the terms "Transnational Corporation" and "Foreign Direct Investment" will be used practically interchangeably. Purists would point out that the TNC is not the only mechanism through which foreign investment can be undertaken. Nevertheless, the focus of our study is that of Foreign Direct Investment made possible through the establishment of a TNC in the host economy.

proposition by considering how the behaviour of TNCs determines the extent to which the benefits of FDI materialise. To maximise the host country's gain from FDI, the objective of FDI policy should therefore not simply be to ensure an efficient (static) allocation of capital. It should rather aim to direct the (dynamic) behaviour of those incumbent TNCs under whose control such capital falls.

The problem of influencing the behaviour of an independent agent is an issue that has been addressed by information economics. This theory focuses on the design of contracts that induce one party to produce the optimum outcome for the other in the presence of conflicting interests. Chapter 4 begins by phrasing the FDI policy problem (of altering TNC behaviour) as one similar to that of moral hazard. This provides a useful way of understanding the issues that need to be addressed by an effective FDI policy.

Before considering the extent to which policy is able to address the abovementioned issues, and the efficiency with which it does so, we need to understand how policies can feasibly be implemented. We see that the limitations on our information force policy makers to target the incentives offered to discernible groups on some selected basis. Since this policy approach is often unavoidable in practice, we cannot criticise it on the basis that it is an imperfect means of attaining our objective. However, where we are able to identify systematic differences according to which these targeted groups may be further sub-divided, we argue that the efficiency of policy can be improved by adopting a differentiated approach.

It is at this stage that we are able to analyse the South African tax holiday scheme. We begin with a brief description of the scheme and of the status of FDI policy in South Africa. Thereafter, we consider reasons why tax holidays may be expected to be less effective as an incentive for foreign firms than is the case for domestic firms. This analysis leads us to conclude that, in the case of foreign investors, tax holidays are less likely to provide sufficiently powerful behavioural incentives. Since it is relatively more capable of doing so for domestic investors, we argue that the failure of the tax holiday scheme to differentiate between foreign and domestic investors has reduced its efficiency. Moreover, this argument supports our contention that FDI policy deserves separate attention and should not be considered under the heading of industrial policy.

⁵ Much of the analysis to follow will present arguments in support of this assertion.

Chapter 6 concludes by presenting the four propositions that embody the central concepts presented in the analysis referred to above.

CHAPTER 2

THE LOCATIONAL DECISIONS OF TNCs

The traditional objective of FDI policies such as tax holidays has been to increase the quantity of FDI flows to the country implementing them.⁶ In order to analyse their efficacy in achieving this objective, we will therefore have to ascertain whether, and to what extent, such policies are likely to influence the TNC's choice of location. The present chapter provides a classification of the various factors that influence the locational decisions of TNCs. Based on this, we shall be able to gauge the relative importance of foreign investment inducements in determining the TNC's choice of host country. The greater the number and importance of influences other than foreign investment incentives, the less likely such incentives are to be the pivotal factor in determining FDI inflows to a particular country.

Our analysis of the influences on the locational decisions of TNCs is presented under three sub-headings. The first set of influences are those that affect the attractiveness of a particular host country, yet cannot be controlled through economic policy. The second set are economic policies other than those specifically designed to attract investment. The latter form of policy ("incentivisation policy") is analysed thereafter. The final section of this chapter draws certain conclusions from the preceding discussion. The following tabulation serves as a point of reference for the discussion to follow.⁷

⁶ See footnote 2.

⁷ The tabulation is not exhaustive and is designed solely to support the central proposition of the present chapter, which is presented below.

Table 1: Taxonomy of factors influencing the locational decisions of TNCs

<u>Non-policy influences</u>	<u>Non-incentivisation policy influences</u>	<u>Incentivisation policies</u>
• Market size • Manpower costs • Political stability and crime • Infrastructure • Natural resources • Market concentration • Macroeconomic stability	• Taxes • Trade policy • Protection of intellectual property • Labour market measures • Domestically-produced input requirements • Tariff drawback schemes • Export incentives • Employment premiums • Investment opportunities created by government policy • Exchange rate • Inflation • Current account balance • Budget balance	• Tax incentives: * Tax holidays * Depreciation allowances • Subsidies: * Research and Development subsidies * Interest rate subsidies * Training subsidies * Infrastructure subsidies • Grants

In the above table, we have presented a number of factors that influence the TNCs choice of host economy. These consist of factors that are (respectively) outside of, and within, the control of the host government. The latter factors have been further divided into policies that fall outside of, and within, the scope of FDI policy. We look at each of these in turn.

The "non-policy" issues of market size, labour costs, political stability and crime, natural resources, market concentration and macroeconomic stability are crucial influences on the locational decisions of TNCs. Where any of these factors are unfavourable to FDI, such investment will not be forthcoming. Conversely, where they are favourable, the preconditions for investment are in place. Empirical studies have demonstrated that the "non-policy" issues referred to above are dominant in foreign investment decisions.⁸ Although it would be wrong to argue that government policy has no influence on these factors, they are, for the most part, not amenable to manipulation by government.

The next set of influences falls more typically within the scope of government policy. Trade policy, regulations, protection of intellectual property, labour market measures, domestic input requirements, tariff drawback schemes, export incentives, job schemes and investment opportunities created directly by government have been listed under the heading of "non-incentivisation policy" measures. These policies are brought into being because of the existence of certain objectives other than that of attracting FDI. However, since they are important influences on the profit expectations of business, they do have a substantial impact on foreign investment. These "non-incentivisation" policies are able to raise or reduce the cost of doing business in the country or the risks associated therewith. Unfavourable changes in these variables will deter FDI, but to a lesser degree than is the case for the "non-policy" issues. Indeed, FDI is driven to a far greater extent by the general economic climate of the host economy than by the freedom it has to conduct business as it sees fit.⁹

The final class of factors considered was that of FDI policies. Tax holidays, depreciation allowances, Research and Development (R&D) subsidies, subsidised interest rates, infrastructure subsidies and grants have been listed as "incentivisation policies". Although able to increase profit expectations, these incentives will be unable to generate FDI where the basic business conditions are not conducive to investment.¹⁰ This is because profit expectations are influenced primarily by both "non-policy" and "non-incentivisation policy" factors. Since these non-FDI policy changes that would serve to encourage FDI are desirable in their own right, they do not fall under the rubric of FDI policy and may be taken as exogenous insofar as such policy is concerned.

⁸ See Chang (1996), Dunning (1993) and Reidel (1987) in support of this.

⁹ World bank (1985), pg. 130.

Although it is conceivable that foreign investment incentives may be able to make a difference at the margin, their importance should not be over-emphasised. FDI policy should not aim to increase the *general* attractiveness of host to all TNCs. Indeed, studies of the impact of incentive measures on FDI have revealed that they are of marginal significance as they are of a temporary nature. In support of this argument, Dunning (1993) has asserted that "... incentive strategies of host governments may frequently involve unnecessary, expensive and inefficient competitive bidding among themselves."¹¹ Certain studies have even revealed a negative relationship between incentives and FDI, as excessively generous incentives are taken by investors as a signal that the host country constitutes a risky location for investment.¹²

We may therefore expect incentive policies to be of significant importance only when these are *pivotal* in the TNCs choice of host and when they influence FDI in the intended manner.¹³ Moreover, even when this is the case, where the investment is *dependent* on the existence of the incentive, the TNC may withdraw on the termination of the scheme.¹⁴ As the next chapter will demonstrate, FDI policies may be effectively used to channel the behaviour of those that have invested; it is rather upon this objective that FDI policy should focus.

¹⁰ See Helleiner (1989), Chang (1995), Dunning (1993) and Reidel (1987) in support of this.

¹¹ Dunning (1993), pg 176.

¹² See Dunning (1993).

¹³ In practice, we may attempt to ascertain whether the holiday is pivotal by asking applicants whether they would invest in the absence thereof. This would, however, be subject to adverse selection as all firms (whether it is true for them or not) would indicate that it was indeed pivotal. The solution to these sorts of problems is dealt with by designing a screening mechanism that generates a "separating equilibrium". These problems are beyond the scope of the present paper, which limits its discussion of information economics to problems of moral hazard (chapter 4). The interested reader is referred to Kreps (1990), chapter 17.

¹⁴ There are certain policy responses that are able to reduce the incidence thereof. Recipients may be required to undertake that the value of the tax holiday scheme will be repaid if the firm withdraws within a certain period. The amount repayable may decline as the period between expiry of the holiday and withdrawal increases.

CHAPTER 3

THE IMPACT OF TNC BEHAVIOUR ON THE

BENEFITS OF FDI

The principal objective of this chapter is to demonstrate that the net benefit derived from FDI is, to a large extent, dependent on the ongoing actions of the TNC. It therefore becomes apparent that, if FDI policy is able to influence TNC behaviour, it has the potential to maximise the benefits that FDI generates for the host. It is upon the influence of TNC behaviour on the impact of FDI that FDI policy should focus. The precise manner in which TNC behaviour may be influenced by policy measures is a topic we defer until later in the paper.

The present chapter will not provide a comprehensive list of the benefits of FDI. It will also not attempt to either suggest which benefits it is that South Africa should concentrate on extracting, or to propose a set of policies that would maximise each individual benefit. In stead, we consider a select number of benefits, in each case analysing the impact of TNC behaviour on the extent to which that particular benefit eventuates.¹⁵ This will suffice as a basis for substantiating the principal objective of this chapter. It will also inform our subsequent discussion of the manner in which FDI policy should influence TNC behaviour in order to ensure that these benefits are forthcoming.

¹⁵ There is no reason to assume that the costs of FDI are not also ambiguous, or that these are of less importance in determining the overall impact of FDI on the host. Our decision not to explicitly analyse costs and the forces that impact thereon does not imply that we are minimising the importance of these costs, but is rather a consequence of the fact that such an analysis will add little substance to the core proposition of this chapter.

3.1 Benefits of FDI

3.1.1 Employment creation

FDI may create employment within the TNC itself,¹⁶ and by virtue of its backward and forward linkages within the economy. Moreover, if we accept the argument that FDI serves to increase growth,¹⁷ it may indirectly increase employment since economic growth leads to an increase in demand for goods and services and hence an increased demand for labour in order to produce such goods. TNCs may increase employment in a more direct manner, where the TNC demands inputs that are produced domestically; these "upstream" industries may increase the size of their labour force to serve such increased demand.

The effects of TNCs on employment creation are not necessarily positive, however. Indeed, a number of factors associated with multinational presence may offset the employment-creation potential of FDI. Firstly, TNCs may introduce capital-intensive production methods into a labour-abundant economy. If the technology that is introduced by the TNC is labour-saving, the end result may be either a smaller increase in employment (where the TNC establishes a new business) or *increased* unemployment (where the TNC implements the new technology in an existing business). Secondly, the TNC's need for skilled labour may encourage them to utilise expatriate labour. This is an important factor in the case of South Africa where the pool of skilled domestic labour is limited.

The *indirect* effects of TNCs on employment may be substantially more deleterious than the two direct effects mentioned above. FDI may cause domestic producers to be forced out of business if the latter are unable to cope with the competitive pressure to which they are exposed as a result of the TNC's presence. This (again) results in, at the very least, a diminution of the employment-generation benefits of FDI, and frequently generates unemployment. It is factors such as these that frustrate the employment creation potential of FDI.

¹⁶ See Chen (1983), for example, who argues that TNCs often produce manufactured goods which are believed to have a relatively large employment-generation effect.

3.1.2 Technological transfer

The location of a multinational enterprise in a particular economy provides access to the technology embodied in both physical items¹⁹ and in people. There is good reason to believe that TNCs create access to a large amount of technology because they are responsible for a large proportion of the world's total R&D expenditure. Indeed, one study estimates that approximately 80% of global civilian R&D is undertaken within TNC systems.¹⁹ The potential for technological transfer created by FDI may thus be substantial.

It is important to note, however, that mere access to technology does not necessarily imply that it will be assimilated and optimally utilised. The capacity to assimilate technology depends on three factors, namely the amount of research undertaken in the host country, the capabilities of the domestic firms²⁰ and the commitment of the transferor of the technology to adapting its technology to local conditions and to transferring it to the host.²¹ It is the first and third of these factors that are important for FDI policy and that we expand on below.

As regards the first factor, it should be noted that R&D is typically undertaken by the parent company in the home country and transferred to its foreign affiliates.²² Where technology has been developed in a context different from that where it is implemented, the technology may require adaptation to the local conditions. It is therefore in a less readily usable form.

¹⁷ See Ozawa (1992) and Agosin and Prieto (1993) for analyses of the impact of FDI on growth.

¹⁸ Examples of such items quoted by Hall and Johnson (1970) include tools, process information, specifications and drawings.

¹⁹ See Kuper and Cassin (1996), pg. 84.

²⁰ Although this factor is an important determinant of the impact of FDI on the host's ability to benefit from technological transfer, it falls outside of the scope of FDI policy. The following discussion has therefore been relegated to appearing as a footnote.

The higher the technological capabilities of domestic firms, the more able they will be to adapt and implement the technologies to which they are exposed. This is because the cost of adaptation depends upon the size of the gap between the skills, experience and knowledge possessed at a particular point in time and those necessary to effectively absorb the new technology. Thus, although a greater gap implies a greater potential for learning, a greater gap also implies that more ground needs to be covered before the technology may be understood and assimilated.

²¹ For more on this, see Buckley and Casson (1985).

²² See Caves (1982).

As for the third factor, the greater the amount invested by the TNC in adapting its technology and in training the domestic labour force to utilise it, the greater will be the benefits from the exposure to this technology. Commitment to the transfer of technology may be expected to increase where, for example, the TNC requires Intermediate inputs that are compatible with the technology that they are employing and where these inputs must be locally produced.

One may question whether the technological transfer that accompanies FDI is unequivocally beneficial, particularly if the technology is, for some reason, "inappropriate".²³ We shall briefly expand on this argument, using the assumption that the home country is industrialised and capital-abundant while the host is a labour-intensive developing economy.²⁴ The technology that is appropriate in these two different environments will be significantly different as a result of the differences in their relative abundances and scarcities. Capital-intensive methods of production would be inappropriate when applied in a capital-scarce host country. The TNC will choose not to adapt its technology to local conditions where the R&D costs incurred are expected to exceed the private benefits derived therefrom.²⁵ Hence, far from reaping the benefits of the rapid diffusion of new technology, the host may receive a production technology that exacerbates the existing scarcities in the economy.²⁶

3.1.3 Capital formation

Lesser Developed Countries (LDCs) in particular tend to suffer from the effects of having an inadequate capital base and therefore being unable to acquire sufficient international competitiveness or to enjoy adequate economic growth. The prospect of an injection of capital in addition to a reinvestment of future profits²⁷ is therefore highly attractive. In addition, there is also the prospect that TNCs will build any infrastructure that they require for their operations that is not present in the host country. The benefits of investment in fixed capital may also be highlighted by comparing it with alternative forms

²³ For more on the appropriateness of technology in the light of factor endowments, the reader may study the Eckhaus Factor Proportions Theory.

²⁴ Our purpose here is not to revisit the Heckscher-Ohlin theory but merely to illustrate the workings of the argument.

²⁵ See Caves (1982) for more on the extent to which TNCs adapt their technology to local conditions.

²⁶ The link between the labour intensity of technology and the impact of FDI on employment creation has already been considered in section 3.1.1 above.

²⁷ Evidence seems to indicate that the extent of reinvestment of profits is significant. See Kuper and Cassim (1998), pg. 83 "Estimates suggest that total profits generated by foreign affiliates worldwide were some \$175bn in 1994, a significant part of which is reinvested." [Own italics]

of investment such as portfolio flows. The risks associated with the latter have been well demonstrated by the Mexican crisis of December 1994.²⁸

One may initially be surprised to learn that capital formation is a benefit subject to controversy. Certainly, the very definition of FDI tends to imply a process whereby foreign capital is brought into the host economy. One will realise that this is not necessarily the case when one considers the possibility that FDI may simply represent a *transfer of ownership* of capital. This is likely to be the case where, for example, TNCs are induced to enter the country due to privatisation measures.²⁹ From the host's point of view, this is a relatively unattractive form of FDI when compared with the same quantity of foreign investment in new productive capacity. This form of FDI may more appropriately be viewed as a financing flow, the effect of which is purely monetary and no real investment is generated.

3.1.4 Mobilisation of foreign savings

FDI has the potential to fill two gaps simultaneously, namely the gap between domestic savings and desired investment and the gap between exports and imports.³⁰ We focus here on the former gap - the latter is dealt with in section 3.1.5 below.

The savings-investment approach to the balance of payments³¹ provides valuable insight into the importance of foreign savings. The central tenet of this approach is that the difference between the level of domestic savings and domestic investment is reflected in the current account balance. Where investment exceeds savings, in other words, where there is a current account deficit, the savings shortfall is made up for by the utilisation of foreign savings. It is through this process that current account deficits are matched with capital account surpluses. FDI is a means through which such foreign savings may be mobilised, thereby financing investment activities within the economy.

Although FDI is typically thought of in terms of direct capital flows, as we have done immediately above, TNCs may also raise capital locally. Where this occurs, it is not

²⁸ See Strydom (1995), pg. 1

²⁹ It is important to understand the extent to which such a form of FDI occurs in LDCs. The data for 1993, for example, reveals that approximately 8% of FDI flows to developing countries took such a form. See Kuper and Cassim (1998), pg. 77. The GEAR policy document (appendix 12) specifically lists the "restructuring of state assets so as to create opportunities for equity investment in public corporations by foreign partners" as a development needed in South Africa to attract increased FDI. We may therefore expect that some of the future FDI to South Africa will not result in new capital formation.

³⁰ This is termed the "two gap" model. See Reidel (1987), pg. 59.

³¹ See Corden (1994) for a complete analysis of this approach.

foreign savings that are being mobilised. Here, FDI becomes financed by domestic savings³² and may possibly draw resources away from other productive uses. Specifically, where a large amount of domestic debt is being raised, investment may be "crowded out" due to the upward pressure placed on interest rates.

3.1.5 Balance of payments support

Since economic growth necessitates increased capital and intermediate goods, many of which must be imported,³³ FDI fulfils the crucial function of financing the balance of payments without incurring the risks associated with foreign debt and short-term capital flows. The risks explicitly considered include the difficulties caused by increased interest rates where foreign debt is high, the fact that altered expectations can cause rapid outflows of short-term funds and the risk that rapid inflows may cause severe currency appreciation and therefore a loss of international competitiveness. FDI is thus seen as a more stable source of international funds than its alternatives.

In comparison to other means by which the balance of payments may be financed, there are benefits to FDI over and above the relative stability thereof. FDI allows the government greater autonomy than does Official Development Assistance because of the concomitant conditionalities that are invariably imposed by multilateral international organisations (e.g. the Structural Adjustment Programmes and Stabilisation measures of the World Bank and IMF).³⁴ As opposed to foreign loans, no recurrent (direct) costs are incurred by the recipient. The importance of FDI increases further if we accept the view of those such as Page (1990) who argues that there is little prospect of increased official flows to the LDC's in the 1990's.

We turn now to the manner in which FDI is capable of generating foreign exchange reserves, thereby improving the balance of payments. Firstly, there may be export revenue generated by the sale of the TNC's output to purchasers outside of the host

³² Reidel (1987) pg. 70.

³³ South Africa is an economy that is particularly reliant on such capital and intermediate goods. It is therefore unsurprising that the GEAR policy document explicitly considers the ability of FDI to finance such imports. See GEAR policy document, appendix 12.

³⁴ The World Bank has stated that Structural Adjustment Programmes have in fact served to increase the flow of FDI to LDCs implementing them - World Bank Development Report (1994), chapter 5.

country.³⁵ Secondly, the capital account may be strengthened by the inflow of investment capital while the ploughing back of revenue increases the injection of capital by the TNC.

The abovementioned *potential* for TNCs to generate foreign exchange revenues is undeniably large. Whether or not this potential is realised depends firstly on whether (and to what extent) the corporation becomes involved in exporting; secondly, on the extent to which profits are repatriated (be it through dividends, interest payments, royalties, management fees etc.); and thirdly on the extent to which the corporation imports goods or services. Some studies³⁶ have found that the relationship between FDI and the net balance of payments can be *negative*. The TNCs studied therefore tended to import in excess of what they exported and made fairly large payments abroad. In addition, the remission of funds abroad may take a form that is somewhat less overt.

Transfer pricing is the means through which revenue earned by the corporation is clandestinely transferred elsewhere, thus causing a loss of foreign exchange.³⁷ Casson, however, states that importance of such activities to TNCs may well have been exaggerated: "The evidence that [intra-firm trade abuses] are the principal motives for establishing [TNCs] is distinctly lacking."³⁸ The incidence of transfer pricing is most likely to be even lower in the 1990's than in prior decades due to increased trade liberalisation and relaxation of exchange controls.³⁹ The problem will nevertheless continue to be a real one.

3.1.6 Increased tax revenue

Although this concept is relatively self-explanatory, in that FDI results in increased economic activity on which taxes can be levied, it is subject to some of the same counter-arguments as those relating to increased export revenue. Transfer pricing serves to reduce the income declared in the host country, which therefore reduces income tax generation. In addition to this, tax revenue generated will be reduced where

³⁵ Economists such as Agosin et al. (1993) see exports as an engine of growth and technological transformation, thereby arguing that the importance of exports extends beyond merely supporting the balance of payments.

³⁶ See Hood and Young (1979), for example.

³⁷ The issue of transfer pricing will reappear in our discussion of tax revenue generation since amounts transferred escape the tax net.

³⁸ This issue was dealt with in the context of South Africa by Wood and Moll (1994), who, in a discussion of the extent of underinvoicing, assert that: "Under close scrutiny, claims that huge amounts of capital were spirited out of South Africa through export underinvoicing during the 1970's and 1980's appear to lack empirical support." See Wood and Moll (1994), pg. 42.

³⁹ South Africa is a case in point.

tax incentives are offered to TNCs. Naturally, in the case of tax holidays, there is zero income tax generated for the duration thereof.⁴⁰ If TNCs qualify for other grants in addition, FDI may actually serve as a *drain* on the fiscus. In support of the view that the tax revenue benefits of FDI are generally unimpressive, Todaro⁴¹ argues that tax incentives and concessions are the most significant contributors towards the low level of tax revenue generated from corporate activity. He has estimated tax on corporate profits to be at approximately 3% of GDP in most LDCs (as compared with in excess of 6% in the Industrialised Countries).

3.1.7 Linkage effects

The presence of a TNC may be critical in providing a competitive advantage to other producers within the economy. The TNC may, for example, provide low cost inputs or high quality producer services. Indeed, TNCs are often able to provide these services (such as telecommunications, financial services and utilities) at lower cost and with greater efficiency. Moreover, there may be a "crowding in" effect in that the availability of high quality producer services will encourage the entry of further TNCs that require such services for their own success. FDI in the service sector is thus revealed to be of great importance. These arguments apply equally to the production of goods, particularly intermediate goods.

On the other hand, the interdependence of TNCs and domestic producers may, at best, be limited and at worst be positively detrimental. As to the first issue, the TNC may operate in relative isolation by importing the majority of its inputs⁴² and exporting the majority of its output. This may be especially true under a global production strategy where the explicit intention is to export its output of intermediate goods (as opposed to supplying the domestic demand). Economists such as Abidin et al. (1983) support the view that few linkages are made by TNCs.

Concerning the second issue, if the TNC enjoys a monopoly in the production of an input, it may reduce the competitiveness of the industries reliant on this input if it engages in monopoly pricing. In addition, there is no guarantee that the TNC will actually be more efficient or produce goods and services of a higher quality than a domestic firm. We may

⁴⁰ Tax holidays do not, however, completely deprive the host of tax revenue as there are other taxes and levies from which recipient TNCs are not exempt.

⁴¹ Todaro (1989) pg. 555.

⁴² See section 3.1.5 above

thus conclude that the impact of any linkages that do exist between TNCs and other producers in the economy is dependent on the behaviour of the specific TNC. Important variables include the ability and desire of TNCs to exert market power, which is the next issue we consider.

3.1.8 Increased competition

The importance of competition in determining the impact that FDI has on the host has been noted above in our discussion of linkages. It is therefore crucial to understand the impact that FDI has on competition. Since the entry of a TNC introduces a new producer into the economy, FDI is typically expected to increase competition.⁴³ Even in the case where TNCs enter a vacant market, the TNC will not necessarily behave monopolistically. Here, it is the contestability of the market that is the important question. The benefits from increased competition such as reduced prices and improvements in the quality of output are discussed in most elementary economics text books and shall not delay us here. We now consider the possibility that FDI may reduce levels of competition within the host.

Cowling and Sugden (1987) have asserted that "... Transnational Corporations are of increasing importance and they imply increasing market domination..."⁴⁴ If domestic producers are unable to cope with the competitive pressure exerted by TNCs, the TNC may enjoy a monopoly position. The effect of FDI will thus be to *reduce* the level of competition and to increase market domination. The risk of this occurring is even greater where, due to their similarity, operating in different markets, TNCs have the ability to use predatory tactics such as cross-subsidisation. Moreover, FDI (or the prospect thereof) may have negative consequences for the host country due to the reaction of domestic producers. The prospect of foreign corporations entering the market and increasing competition is patently not in their interest and may therefore result in entry-forestalling behaviour or rent seeking ("lobbying").⁴⁵

3.2 Conclusion

The aim of this chapter has not been to provide an exhaustive analysis of all of the possible consequences of FDI or to provide a definitive answer as to whether FDI is desirable. Indeed, if this chapter is to fulfil one objective, it is to show that such definitive

⁴³ Julius (1990) asserts that the evidence confirms that this is the overall effect of opening markets to FDI.

⁴⁴ Cowling and Sugden (1987), pg.4.

answers cannot be given. Unqualified assertions that FDI will produce a particular benefit would be naive and would result in misguided policy. This notwithstanding, we can make one crucial substantive proposition.

The extent to which the benefits described above are expected to materialise is chiefly determined by the behaviour of the TNC, which behaviour may be influenced by policy measures. For example, TNC's ability to exert market power may be reduced by closing vulnerable industries to private enterprise, or by establishing a body that will monitor competitive behaviour of TNCs. The repatriation of capital and earnings may be reduced by placing restrictions thereon or by levying taxes. The ability of TNCs to undertake transfer pricing may be reduced by monitoring payments between related business entities to ensure that they are market-related.

It is possible to list many more policy measures that may increase the benefits derived from FDI by influencing TNC behaviour. It is not, however, the intention of this paper to suggest a comprehensive policy framework by which each benefit listed above may be maximised. This would require an assessment of (*inter alia*) industrial policy, competition policy, FDI policy and trade policy. At this stage, it will suffice for us to note the critical role that FDI (and other) policies may potentially play in ensuring that FDI flows serve to benefit the recipient country. The following chapter analyses whether FDI policy is able to meaningfully contribute to this objective, in which case, we will have identified the appropriate focus of such policy.

⁴⁵ For a more complete discussion, the reader is referred to Buckley and Casson (1985).

CHAPTER 4

A THEORETICAL APPROACH TO FDI

POLICY

Having identified the importance of TNC behaviour on the impact of FDI in chapter 3, we now need to analyse whether FDI policy will be able to influence such behaviour. In order to gain a clear understanding of the problems that a policy with this objective must address, we phrase the policy problem as one of moral hazard. Doing so will highlight the problems involved in creating incentives for an independent agent to behave in a certain manner.

4.1 Information economics and moral hazard

Moral hazard is considered to exist where (a) one party to a transaction may undertake certain actions that affect the value of that transaction to the other party, and where (b) the latter is unable to perfectly monitor or enforce the transaction in question. Insofar as the first component of this definition is concerned, the ability of one party to affect the value of the transaction to the other implies that the activities of the former create externalities. Where the self interested behaviour of the former cause it to act in a way that is not in the interest of the latter, we say that there exists a *conflict of interest*. As regards the second component of the definition, the inability of one party to ascertain precisely what actions the other has taken therefore results in an *information asymmetry* - the information possessed by one party is inferior to that possessed by the other.

We may illustrate the difficulties created by moral hazard with the use of a common application thereof, namely insurance. The likelihood of a particular loss that has been insured against eventuating is often affected by the actions of the insuree. The extent to which the latter undertakes actions so as to reduce this likelihood thereby affects the expected payout by the insurer. In a similar fashion, the benefit of Foreign Direct Investment to the host depends significantly upon the actions of the TNC.

Where it is possible to monitor the actions of the other party directly and to enforce the desired actions by way of a contractual agreement, the issue of moral hazard does not

arise. In cases where such monitoring proves either impossible or infeasible, the solution lies in the creation of incentives for the party who undertakes the actions to behave in a manner more consonant with the interests of the other party.⁴⁶ In the context of insurance, the usage of excesses (where the insuree bears a fraction of the costs imposed on the insurer) increases the degree to which the interests of the insurer and the insuree coincide. This is not to say that the interests of the insuree would not be better served by the absence of such excesses, but the imposition of such a cost on the insuree aligns the latter's interests with that of the insurer more closely.

Above, we have discussed the fact that the two central elements of moral hazard problems are those of conflict of interest and information asymmetry. Below, we analyse the extent to which each of these presents itself in the case of FDI.

4.2 Conflict of interest

The importance that the ongoing behaviour of TNCs has in determining the impact that FDI has on the host economy would present little problem if the interests of the TNC were identical to those of the host. Were this the case, the TNC's pursuit of its self-interest would lead TNCs to promote the interests of the host simultaneously. It would therefore be unnecessary to implement policies designed to influence TNC behaviour once they had invested. We shall see, however, that there are a number of respects in which the interests of the TNC and the host diverge, which has important implications for policy.

The basis of the conflicts of interest that we consider below is that the TNC behaviour is motivated by the pursuit of shareholder wealth and its behaviour is therefore based on the private costs and private benefits thereof. The host government, on the other hand, is concerned about social costs and benefits.⁴⁷ This section provides concrete examples of the manner in which this divergence of objectives manifests itself.⁴⁸ Before doing so, it is important to reinforce a point made earlier in the paper, namely that there will be a

⁴⁶ The reader should note the importance of the ability to monitor actions. This will be given specific attention below in the context of TNC behaviour.

⁴⁷ When the private and social costs and benefits diverge, we are confronted with a problem of externalities since the TNC can impose costs or benefits on the host that it does not face. See Bilgilitz (1988) for a good reference on externalities and the importance thereof in the economics of the public sector.

⁴⁸ The conflicts of interest to be considered below are not peculiar to TNCs. Since domestic firms also focus on private costs and benefits, similar conflicts are to be expected between the interests of domestic firms and those of government. These would require explicit attention in the design of industrial policy. However, in the present paper, the conflicts considered in the text are raised solely with reference to their implication for FDI policy.

significant overlap between the issues that are important to FDI policy and industrial policy. The conflicts of interest to be discussed below are not unique to TNCs. However, in the same way as they would require attention in the design of industrial policy, we need to consider them here since we wish to analyse FDI policy in an informed manner.⁴⁹

First, consider the benefit of tax revenue generation.⁵⁰ Since taxes represent a direct transfer from the TNC in question to the host government, the interests of these two agents are in direct conflict. The practice of transfer pricing allows TNCs to shift profits between the two firms involved in the relevant inter-company transaction. One of the principal effects of transfer pricing is to reduce the income tax payable thereon in one location and raise it in another. Any attempt by a TNC to reduce its taxable income in the host in order to undertake such "tax arbitrage" is patently not in the interests of the host government.

Second, we turn to the cost of environmental degradation where the activities of the TNC pollute the environment or deplete natural resources. Because such negative externalities are not taken into account by the TNC, it produces an output in excess of the socially optimal quantity. The host will therefore wish to induce the firm to reduce its scale of production.

Third, the interests of the host and the TNC may be directly in conflict insofar as market power is concerned. Whereas the TNC has an interest in reducing competition in the industry it has entered in order to enjoy economic rents, the host will wish to avoid any increased output prices and restrictive practices that are the concomitant of monopolistic behaviour.

Fourth, consider the benefit to the host economy of capital inflows. Since the TNC is an investor, it makes a present outlay in order to enjoy a future stream of cashflows and will therefore ultimately wish to remit a proportion of the funds generated back home. *Ceteris paribus*, this is in conflict with the desire of the host economy to retain, and preferably increase, its foreign capital stock. The greater the proportion of profit that is ploughed

⁴⁹ Behavioural differences between domestic and foreign firms will receive attention at a later stage in the paper. These differences do not, however, emanate from a difference in the manner in which foreign and domestic firms pursue shareholder wealth.

⁵⁰ See 3.1.6 above

back instead of being remitted abroad, the faster the rate at which the capital base will increase. *Ceteris paribus*, the host will therefore wish to reduce the repatriation of profit and capital by TNCs.

Finally, whenever domestic and foreign inputs into the production process are substitutes, the potential for conflict of interest arises. There are indeed a large number of examples of such substitutes including raw materials, capital and intermediate goods, and human capital inputs. The TNC has a choice between, for example, importing expatriate skilled workers or employing (or creating) such skilled labour domestically. In particular, where the TNC utilises domestic inputs, it creates economic linkages (as discussed in section 3.1.7 above). Since this is desirable from the point of view of the host, a conflict of interest may arise where the TNC expects *foreign* inputs to generate greater profit.

The above list of potential conflicts of interest is by no means exhaustive. Moreover, space does not permit an attempt to resolve all of the conflicts of interest that we have mentioned. Our discussion has solely been designed to demonstrate the following important point. In prescribing FDI policy, we will need to reconcile the interests of the host and the TNC, as these are often in conflict. What we now discuss is the problem presented by information asymmetry in resolving such conflict.

4.3 Information asymmetry and the difficulties of monitoring and enforcement

From the discussion above, it might appear that there is an obvious policy solution to the conflict of interest between the TNC and its host. FDI policy may simply comprise a set of rewards for that behaviour which maximises the benefit of FDI to the host. However, even in the presence of adequate incentives, such policy will only be capable of altering the behaviour of TNCs if one can monitor whether the behaviour which is being rewarded has actually occurred. The importance of this issue leads us to analyse the extent to which various forms of TNC behaviour, and the impact of such behaviour, may be monitored.

The extent to which the actions of TNCs and their impact are observable depends primarily upon what action it is that we are considering. On the one end of the spectrum are actions that are readily observable and quantifiable. Although we do not monitor the actions of the TNC as these occur, we are able to observe the direct and concrete

outcomes of such actions. Examples include the TNC's utilisation of domestic labour and domestic inputs as well as income tax revenue generated from the TNC.

Towards the middle of the spectrum are factors that are still quantifiable, yet the host will encounter difficulties in doing so reliably and accurately. These factors tend to be less able to indicate the precise actions that have been taken.⁵¹ The first type of such factors are those which are prone to manipulation and concealment by the TNC (usually due to tax or exchange control considerations) such as capital inflows and outflows.

The second type of factors are those which are only measurable by means of a sector-by-sector (or even firm-by-firm) analysis across the entire economy. In all cases where TNCs affect other firms within the economy, this is the difficulty that we encounter in measuring the overall impact of FDI. An example taken from chapter 3 is that of economy-wide employment creation.

On the other end of the spectrum are the qualitative variables. These are the most difficult to monitor and enforce as they are less likely to have any physical manifestation whatsoever. As a result, those signals that do exist are influenced in a rather indirect manner. Such factors are therefore a highly imperfect indicator as they are typically influenced by a variety of other circumstances. A second problem is that quality is less conducive to measurement and attempts at measurement are often subjective. Moreover, measurement in any form requires an understanding of the arena being investigated and is therefore skill-dependent. From a policy perspective, these variables therefore present the greatest difficulty. An example of such a variable and the signal thereof are, respectively, the *quality* of training provided by the TNC to employees and worker productivity.

The conclusion from the analysis above is that it is only the *direct* and *quantifiable* impacts of the TNCs that may feasibly be observed with any precision. Since the focus of our analysis is the impact of FDI on the host economy as a *whole*, combined with the fact that the most substantial benefits of FDI are those that are dynamic and indirect in

⁵¹ It is precisely such factors that are employed in moral hazard mechanisms as indirect indicators of the actions of TNCs. We shall discover that despite the fact that they do not perfectly indicate the actions of the TNC, they are a second best solution to the problem. The fact that they are manipulable implies that the proxy chosen, and the direction in which TNCs will be induced to manipulate it, must be in the host's interests. If, for example, economic growth was the proxy chosen, upward manipulation of this proxy by the TNC (if this was possible) would be to the host's benefit.

nature,⁵² we would ideally like to observe more than just those factors directly affected by the actions of the TNC.⁵³ However, the practical difficulties noted above cause this to be infeasible, and we now consider why this is the case.

Where the action in question cannot be monitored directly, we either need to measure the indirect effects of the action (such as the impact that one TNC has had on the labour employment of other firms) or we need to adopt some indicator of the actions taken. The practical difficulties involved in the economy-wide analysis that is required for the first option are obvious. Not only is the scale of the analysis prohibitive, but there is the counterfactual problem that it is impossible to determine how other agents would have behaved had the initial action not occurred. Insofar as the second option is concerned, different, but equally formidable problems present themselves.

The indicator selected should be something that is directly and observably altered by the level, intensity and form of the action in question.⁵⁴ Moreover, this indicator should, itself, be relatively susceptible to monitoring. Information economics teaches us that imperfections are inherent in the use of such signals. This is because, where the actions of one party cannot be observed directly, we must rely on the fact that the such actions affect the *probability* of a particular (observable) outcome occurring. Since it is the outcome itself (i.e. the signal) that we are observing and using as a measurement, it will be an imprecise one where there are any exogenous factors that affect such signal. Indeed, the theory of moral hazard is designed to generate an optimal outcome under precisely such circumstances.

⁵² See Zainuddin (1993) in support of this.

⁵³ However, although insufficient in isolation, it is not being suggested that policies based on the direct impact of TNCs have no merit. Everything else being equal, where policy-makers are able to influence the actions of TNCs by monitoring those factors that are directly observable, the former will wish to do so. For example, although the overall impact of the TNC's behaviour on national employment may principally be through its impact on other firms in the economy, everything else held constant, we will prefer the TNC to employ a greater number of domestic labourers. A component of the policy prescriptions to be presented below will therefore entail precisely such policies which, when coupled with policies to reduce any harmful indirect effects, will increase employment generation.

⁵⁴ This ties in closely with the literature on executive compensation. Here, the only manner in which the actions of executives may be perfectly monitored directly is for an observer to be witness to all the actions of the executive and to be sufficiently knowledgeable to understand their implications. Since this is duplicative and wasteful, the firm is forced to rely on a "proxy" for the extent to which management behaviour enhances shareholder wealth. Among the proxies (i.e. indicators) from which one may choose are share price, profit and earnings per share.

For one of the most influential founding articles which applies agency theory to the topic of executive compensation, the reader is referred to Jensen and Meckling (1976). For interesting analyses of alternative compensation packages and the difficulties involved in aligning the interests of the managers and the firm

From the discussion above, it should be evident that information economics addresses problems very similar to those involved in the design of FDI policy. It is therefore disappointing to discover that the solution proposed by the theory has little practical use. The theoretical solution to the problem of moral hazard involves a number of steps that cannot be taken in reality. The most problematic of these is specifying the agent's utility function, which is to be used to ascertain the minimum payment necessary to induce the agent to enter into the contractual relationship⁵⁵ and the utility associated with different payments and different actions.⁵⁶ Since the information necessary to specify the utility function is unobtainable, we cannot determine the abovementioned data and it is therefore not possible to implement the optimal contract. Moreover, this optimal contract would have to have been implemented on a case-by-case basis since the contract would change as the parameters of the utility function changed. The absence of the necessary information denies us the ability to distinguish meaningfully between each individual TNC based on its idiosyncrasies. The difficulties in applying information economics do not, however, stop here.

Although moral hazard involves the use of an imperfect signal, the latter is still modelled as a comparatively reliable indicator of the hidden action. However, the greater the number of exogenous factors that impact on the signal, the more imperfect is that signal, and therefore the less certain we can be that a change in the indicator is a consequence of the action we wish to monitor. The weaker the line of causality between the action and such signal, the less impact the agent will realise that he has on such indicator, and therefore the weaker the incentive created by rewarding the agent based on this signal. Since we are interested in the overall impact of TNC behaviour on the economy, the signal that we would select for FDI policy would ideally indicate such impact. The line of causality between such signal and the behaviour of each individual TNC will be particularly weak as we are dealing with one among numerous agents whose actions impact on this signal.

Despite the inability of information economics to offer practicable solutions to the problems faced in the design of FDI policy, the attention it has received in this paper is

more closely, see Brander and Poitevin (1992), Lewellen et al. (1992), Finkelstein and Hambrick (1989) and Tzur and Yaari (1994).

⁵⁵ This is termed the "participation constraint", defined as the constraint that the agent wishes to enter into the contractual relationship, which depends on the agent's reservation level of utility (defined as the utility derived from the next best alternative to the contract).

indeed justified. The theory provides a new lens through which such problems may be seen. In the following section, we consider how those policies designed to solve such problems may be implemented in practice.⁵⁷

4.4 Policies in practice

The limited resources and administrative capacity of government coupled with the absence of the relevant information (the implications of which have been noted above) forces us to rely on certain simplified policies in practice. The objectives of policy makers are more modest than to implement policies able to maximise the net gain to the host. They have to rely on the use of certain simplifications which are a pragmatic response to the limitations referred to above. The following approach may be adopted.

All investment projects by potential TNCs may be evaluated using pre-specified guidelines. This increases both transparency and the perceived certainty by potential investors whilst avoiding the resource commitments necessary to undertake case-by-case analyses. The cost will necessarily be the ability to tailor one's approach according to the specifics of the case at hand, by which the host would, in theory, have been able to extract the maximum benefit. The need for increased certainty is due to the ability of TNCs to be selective in their choice of host countries and therefore their increased sensitivity to these policies. Frequent rule changes as well as excessive discretion will discourage FDI due to increased uncertainty. Automatic approval for investment proposals that comply with certain requirements may therefore be warranted (with the possible exception of investments that are either large or are in industries that the government specifically wishes to promote).⁵⁸ Moreover, such an approach reduces the incentive for firms to engage in rent-seeking behaviour.

An important question is the level of generality at which these simplified policy rules should be applied. The following two solutions may be suggested.

⁵⁶ Which, in combination, set the "relative incentive constraint" (defined as the constraint that the agent finds it more attractive to undertake the action that the principal wishes than any alternative action).

⁵⁷ Once again, it must be stressed that the following section will not attempt to propose a set of policies to be designed such that FDI generate the maximum benefit to the host. It is simply intended to temper the preceding analysis by illustrating the manner in which policy makers may attempt to deal with the constraints on implementing optimum policy. This will be an important basis on which to analyse the South African tax holiday scheme.

⁵⁸ Agosin and Prieto (1993) are also in favour of the use of a negative list (i.e. closed industries are enumerated and all industries outside of these are accepted).

The first choice is to apply these simplified rules to all firms across the economy, independently of their case specificities. This we may do by isolating certain benefits deemed to be the most important to the national welfare and creating incentives for any firm to pursue these. Since we have not discriminated between different firms on any *a priori* basis, the relevance of the uniform set of policies will vary between such firms depending on the extent to which each provision applies to the activities of each individual firm. The underlying logic is that where the desired economic objectives are attained, the specific nature of the TNC that generated such result is irrelevant. In fact, to progress the argument further, it matters little whether the benefit is generated by a foreign or domestic firm.⁵⁹

The disadvantage of this level of generalisation is that a proportion of government resources will be utilised without generating any concomitant benefit. The more widely the same policy is applied to variegated individual cases, the greater the scope for such a policy to diverge from that which would be optimal for the case in question. Where a standardised reward is offered to firms with different propensities to behave in the desired manner, such rewards will consist of economic rents to varying degrees. Since the optimal incentive schemes discussed above are those where both the "participation" and/or "relative incentive" constraints are binding, no economic rents should exist. Therefore, the greater the generality with which reward mechanisms are applied, the greater the proportion of resources employed that will be unproductive (i.e. not contribute towards altering TNC behaviour).

We therefore conclude that such policies should only be implemented where the host feels unable to isolate any systematic differences between different types of firms. Where no differentiation is made between the treatment of different groupings of firms, the host must be unable to identify (a) systematic differences in the value placed on a particular incentive policy by these groups, (b) systematic differences in the propensity of the groups to behave in the desired way in the absence of incentives, or (c) benefits that one group is more capable of producing than the other.

Where the government is able to make such a distinction, we may choose to implement certain simplified decision rules to tailor policies, at least to a limited extent. We could

identify certain distinguishing characteristics such that projects which possess these are different in one or more of the respects listed above. Where some group is more likely to promote the national interest when they do behave in the desired manner, we may wish to channel relatively more resources in their direction. Where firms belonging to a discernible group are more likely to behave in the desired manner, weaker incentives may be necessary than for other groups. Where the same policy is valued less by some grouping of firms, larger rewards will be required to generate an equal effect. These adjustments to policy may be implemented according to variables such as the sector of the economy in which the investment occurs, or the geographic location of such a project within the host, or the identity of the home country of the investing TNC.

Consider a segmentation-by-industry process. We may analyse different industries according to their R&D intensity, labour intensity, capital intensity, skills development orientation, export orientation and the extent to which they are vertically linked with other sectors of the economy. Based on this analysis, different industries may be classified as "R&D intensive", "labour intensive" ... and so on, which we do by defining benchmarks by which intensity may be classified.⁵⁵ Although the cut off point between those industries that qualify as, for example, labour intensive and those that do not is an arbitrary decision, it does allow some form of concentrated policy effort in those sectors that are most likely to produce the desired results.

The problem with segmented policies is the difficulty in determining which groupings (by economic sector, geographic region or home country) are most able to promote which benefits and to what extent. Such a targeted approach forces us to "pigeon hole" every group within the economy according to their ability to attain the different economic objectives. Those sectors that do not receive the incentives to pursue a certain objective are, by default, relatively disincentivised to do so. The difficulty of implementing targeted policy is well illustrated by the inability of other countries to replicate the success of the

⁵⁵ It is submitted that it is this logic which underlies the present policy stance in South Africa.

⁶⁰ One might argue that it is appropriate to base our assessment of these intensities and orientations on observations of the industries of foreign countries at a similar stage of development, as opposed to analysing the domestic situation. For example, where the R&D intensity in a particular sector of the domestic economy is noticeably below that observed internationally, this may imply that this is a good sector to target for R&D subsidies as there may be significant potential for this sector to catch up to international levels. One must however take cognisance of the possibility that there are medium- or long-term factors that are peculiar to the domestic economy which have caused this divergence from the international norm, and will continue to do so independently of policies implemented.

NIE's targeted industrial policies - picking⁸¹ "winning" industries is an extremely difficult exercise. Consequently, one should be wary of suggestions that our chances of implementing a successful targeted FDI policy are much greater than is the case for targeted industrial policy.

The defensibility of using segmented approaches depends on the extent of government's confidence in accurately assessing the ability of each grouping to promote each policy objective and the resources at their disposal to provide the incentives in question. The greater the scarcity of resources and the more able the government is to earmark groupings for specific objectives, the more attractive are targeted policies. Where the opposite is the case, generalised policies may be called for. In cases where the country is resource-constrained and feels unable to target sectors, the number of different policy objectives (and the resources allocated thereto) may need to be reduced whilst the incentives are applied to all firms across the economy.

⁸¹ Although beyond the scope of this paper, the question of whether the NIEs picked or created their "winners" is an interesting one.

CHAPTER 5

SOUTH AFRICAN POLICY APPLICATION: TAX HOLIDAYS

This chapter begins with a brief discussion of the status of FDI policy in South Africa. It then proceeds to set out the relevant features of the South African tax holiday scheme. The third section analyses the monetary value of the tax holiday scheme to its recipients. We discover that a systematic difference exists between its value to domestic firms and TNCs as a whole. This leads us to two important conclusions. Firstly, the efficiency of the tax holiday scheme could be increased by adopting a differentiated approach based on this systematic difference. The second is a more general point, namely that by having identified a benefit that could be derived from differentiating between foreign and domestic firms for the purposes of policy, we have indicated that there may be grounds to criticise the absence of any FDI policy in South Africa.

5.1 FDI policy in South Africa

In South Africa, there is no FDI policy *per se*. The Companies Act 61 of 1973, makes no distinction between companies that are locally-owned and those that are foreign-owned. Moreover, any foreign company may establish a place of business and carry on business activities locally without having to form a separate locally-registered company.⁶² Such companies may simply be registered as an "external company" and are not required to appoint a local board of directors. For the most part, they have the same rights as companies incorporated within South Africa.⁶³ As a result, there are various industrial policy measures that apply to domestic and foreign firms equally. Although these do not focus on FDI specifically, they obviously affect FDI flows and the behaviour of TNCs. South African policies therefore correspond to the generalised policies considered in section 4.4 above.

⁶² Banking and insurance companies are the exceptions to this.

⁶³ A distinction is, however, made between local and foreign companies in respect of exchange control matters. For example, where 50% of the voting stock, capital or earnings of a local company is held or controlled by a non-resident, prior approval by the South African Reserve Bank is required for the company

5.2 The three components of the South African tax holiday scheme

As from 1 October 1996, firms have been able to make an application to the Department of Trade and Industry to be granted a tax holiday in South Africa. Applications will only be accepted up until 30 September 1999, and a number of preconditions must be complied with.⁸⁴ Firstly, the enterprise must be in the manufacturing sector of the economy. Secondly, it must be the first time that the firm has commenced such a project. Thirdly, the project must be the sole trade of the firm. Fourthly, the project must not be principally the same as one already being carried on by another enterprise in South Africa. Fifthly, the application cannot be made after such a project has already commenced. Finally, capital invested in land, buildings and machinery must exceed R3 million.

The stated objective of tax holidays is to encourage investment in manufacturing, assist local manufacturers in improving their international competitiveness and facilitate a higher degree of labour absorption. Accordingly, the duration of the holiday depends on three components based on which the potential recipient is judged. For each of these components complied with, the applicant receives a two year tax holiday up to a maximum of six years.

The first of these is the "spatial component". This requirement is designed to serve the purposes of the Regional Industrial Development Programme (RIDP). To comply with this requirement, the production facilities must be located in one of the pre-specified "manufacturing development zones", a list of which is available from the Department of Trade and Industry.⁸⁵

to receive a local loan. This notwithstanding, the important point is that there are no distinct set of FDI policies, and industrial policies apply equally to foreign firms.

⁸⁴ See section 37H(1), Revenue Laws Amendment Act 46, 1996.

⁸⁵ The purpose of this chapter is to analyse whether the ability of policies to attain their stated objectives will differ between foreign and domestic firms. As such, we have not attempted to assess the merit of the policies in question. However, in the case of the RIDP, it would be remiss not to briefly discuss its background and impact.

The RIDP was introduced as a last attempt to make the "Bantustans", upon which the apartheid edifice rested, economically sustainable by encouraging firms to relocate their operations in these (otherwise unattractive) regions. The programme has come under severe criticism from authors such as Hirsch (1991), who has argued that "the costly programme is nothing more than the idealistic attempt to recreate South Africa in the divided image of apartheid, and it in no way reflects the desires or the needs of other sections of South African society, and certainly not the interest of the business community." (pg. 145).

Moreover, the data on the overall impact of the RIDP (independently of any differences between domestic and foreign firms) seem to indicate that industrial decentralisation has not led to a more equitable regional distribution of wealth. Hirsch supports this contention by observing that the number of entrants into the labour market in decentralised areas greatly exceeds the number of employment opportunities created. Decentralisation efforts have also not led to significant regional multiplier effects as the majority of inputs are imported from areas outside of the manufacturing development zones. Similarly, the output is exported to areas outside of these zones. There is also little reinvestment of profits by firms. (Hirsch, pg. 169).

The second component is an "industry component". Once again, a list of qualifying industries is set out by the Department of Trade and Industry. Qualifying industries have been limited to those that fall within "Major Division 3" of the Standard Industrial Classification.⁶⁵ These qualifying industries have been identified as possessing one of the following characteristics. They may be labour intensive, have strong economic linkages, be sensitive industries that have been adversely affected by tariff reform or industries identified by the Department as having the potential to secure a larger share of the world market. Due to the variegated and imprecise bases upon which industries are able to qualify, there is no obvious pattern between the 96 that have been selected other than the fact that they are almost exclusively in manufacturing.⁶⁷

Finally, there is a "human resource component", according to which the ratio of human resource remuneration to value added is measured. Human resource remuneration must equal or exceed 55% of value added in order to satisfy this component.^{68 69}

For analytical purposes, it will be useful to classify the first two components of the tax holiday scheme as "pre-*ent-ur* conditions" since they are designed to impact on where investment occurs. This is in contrast to the third component that may be defined as a "performance incentive" as it is designed to alter the ongoing activities of the TNC once investment has occurred. We should note that it is therefore the latter component that corresponds most closely to the incentive mechanisms envisaged by moral hazard theory.

5.3 The value of tax holidays to recipient TNCs

Since the tax holiday is designed to create certain financial rewards for investors, it is important that we determine the extent to which it does so. We discover below that the value of a tax holiday is expected to be lower for the average TNC than is the case for the average domestic firm. This is because, in the case where South Africa has a tax treaty with the home country of a TNC, the incidence of the holiday is often not fully on the intended recipient. No such issues present themselves in the case of domestic firms.

⁶⁵ See the *Standard Industrial Classification of all Economic Activities* (fifth edition) issued by the Central Statistical Services in 1993.

⁶⁷ There are certain exceptions, such as service activities relating to printing.

⁶⁸ As to the merit of this component, one might argue that although it may be desirable to increase the labour intensity of production, this must be complemented with an education policy that provides labour with the requisite skills.

⁶⁹ The finer details of these three requirements are details beyond the scope of this study. The reader interested in these is referred to the South African Revenue Laws Amendment Act 46 of 1996.

Any firm that earns a profit in South Africa and that pays out the full after-tax amount as a dividend (net of the STC⁷⁰ thereon) will be taxed at a rate of 42.22%.⁷¹ Consider the case where a Double Tax Agreement (DTA) exists between South Africa and the home country to which such dividends are sent. Where the taxes paid in the former exceed those that would have been levied in the latter, no further taxes will be payable on this dividend income in the home country. Were this same company to be granted a tax holiday, its exemption from South African tax would cause it to face the full amount of corporations tax in the home country. In this case, the greater part of the tax holiday would represent a transfer of tax revenue from the South African government to the home country government. The value of the tax holiday to the recipient is merely the amount by which the South African tax rate exceeds that of the home country.⁷² As an incentive, it is therefore substantially weaker than expected.

In the case where no tax treaty exists, this entire issue falls away since the question of whether taxes are paid in South Africa or not has no bearing on the tax liability of the holding company at home. In this case, tax holidays are a more powerful investment incentive. However, since there are, at present, 31 DTA's between South Africa and other countries and a further 36 at a pre-finalised stage, tax treaties are an important issue in the assessment of tax holiday schemes in South Africa, particularly since many of these countries are important sources of FDI to South Africa (such as the UK, USA, Malaysia, Japan and Germany).

For the sake of completeness, it is important that we consider a factor that impacts on the value of tax holidays to their recipients in the presence of a DTA. Where the home country does not tax the income of the holding company on a source-by-source basis,

⁷⁰ Secondary Tax on Companies – a tax levied at a rate of 12.5% on net dividend payments.

⁷¹ Corporations tax on profit of R100 is R35. If the firm then wishes to pay out dividends such that, after the payment of STC, all of the remaining R65 is exhausted, it will declare a dividend of R57.78. The STC on this will be R7.22. Adding the R7.22 to R35 brings us to the figure of R42.22.

⁷² A case in point is the DTA between South Africa and the UK. First, consider the impact of the DTA where no tax holiday exists. Assume that a South African subsidiary earns a profit of R100 and wishes to pay out the full after-tax amount as a dividend (net of STC thereon). Since the total tax payment in South Africa totals R42.22, the balance of R57.78 would ordinarily be subject to UK tax at a rate of 31% in the hands of the holding company. The DTA causes no further taxes to be payable thereon because the tax paid in South Africa exceeds that which would have been payable in the UK. Now, consider this same company if it were to have been granted a tax holiday. This company would have been able to pay the full R100 out as a dividend, and the holding company would have been liable to pay the full 31% in taxes at home (i.e. in the UK). By comparing the above two scenarios, we see that the value of the holiday to the TNC is a mere 11.22% (the difference between 42.22% and 31%), whereas the cost of the holiday to the South African

the taxes paid on income earned in the various host countries are aggregated. Tax payable in the home country equals the amount by which (a) home country tax on the income from which dividends were paid exceeds (b) the aggregate taxes paid in the host countries. Therefore, if, in one country, the tax actually paid exceeds the home country tax, this excess may offset the tax liability created in other host countries where taxes actually paid fall below the home country amount. In this sense, the excess has become available as a "tax credit". This therefore reduces the disincentive to invest in countries where the tax rate exceeds that of the home country. We shall see below that tax holidays are a weaker incentive here than where the home country has implemented a source-by-source basis for taxation.

Where the home country does tax the holding company on a source-by-source basis, the amount by which taxes paid in the host country exceed those that would have been levied on the relevant income at home does not become available as a tax credit. Therefore, tax rates in excess of those at home are a "pure loss" in the hands of the TNC. Under these circumstances, exemption from such taxes will be a relatively more powerful incentive than where a source-by-source basis for taxation is used. Here, tax holidays are therefore expected to be a (modestly) more powerful policy.⁷³ However, since the financial implication of a source-by-source basis for taxation is limited to the difference between the tax payable in the two countries, it will not substantially influence the impact that DTA's have on the effectiveness of tax holidays. The influence that it does have will depend on the amount by which the tax rate in the host exceeds that in the home. We may therefore conclude that, irrespective of whether source-by-source bases of taxation are used, it is invariably the case that DTA's reduce the value TNCs place on the receipt of a tax holiday rather substantially.

government is the full 42.22% foregone. In effect, the tax holiday in the presence of the DTA represented a transfer of R31 from the South African government to that of the UK.

⁷³ TNCs do, in fact, seem able to side step such source-by-source regulations by establishing a subsidiary of the holding company (an "intermediate company") in a country that does not use such a basis for taxation. This company, in turn, owns all of the subsidiaries and receives all of their dividend income. When the intermediate company pays a single dividend to the original holding company, the dividend income from the subsidiaries in the various host countries are "mixed". Taxes are then calculated on the basis of aggregate taxes already paid and the tax liability for such income in the host country. In this way, taxes paid in excess of the home country amount are offset against those that are below it. Such companies are referred to as "Dutch Mixers" since Holland is the country in which such companies are often registered. It should be noted that not all TNCs are able to take advantage of this mechanism since only the larger TNCs will find the administrative and set-up costs worthwhile. For the most part, source-by-source bases for taxation will therefore modestly increase the relative benefit derived from tax holidays.

5.4 Inefficiencies caused by the undifferentiated nature of the South African tax holiday scheme⁷⁴

In section 4.4, we analysed the implications of an undifferentiated policy approach for the efficiency of such policies. We discovered that, where systematic differences can be identified between the behaviour of different types of firms, government funds may be more efficiently used by adopting a segmented policy approach. In the present section, we apply this principle to the South African tax holiday scheme and the fact that it does not differentiate between foreign and domestic investors. We shall analyse certain intuitive reasons to suspect that systematic differences between foreign and local firms do exist, and that these suggest that the South African tax holiday scheme should apply differently to foreign and local firms.

Before commencing, it must be noted that it is not possible to use intuitive arguments to prove conclusively that the systematic differences to be discussed below do exist. Our purpose here is more modest. We wish to indicate whether there are reasons to suspect that such differences *might* exist. Doing so allows us to generate one important conclusion. Where it is *plausible* that some systematic difference between foreign and domestic firms may be discerned, it is difficult to justify the fact that FDI policy is subsumed under industrial policy unless this has been preceded by an earnest attempt to ascertain such systematic differences and to modify policy accordingly. The precise manner in which it should do so is beyond the scope of this paper since detailed empirical information is required to answer this question.

The first argument in support of systematic differences existing between local and foreign firms follows directly from the discussion of Double Tax Agreements above. In general, we would expect DTAs to affect a greater proportion of TNCs than local firms,

⁷⁴ There are criticisms that may be levelled against the tax holiday scheme other than its failure to distinguish between foreign and local investors. Although important to note, these criticisms are not central to the argument of this paper and have therefore been referred to being footnoted. Firstly, recipients may have an incentive to undertake unproductive activities to facilitate inter-temporal transfers of profits by manipulating profit and loss account items. They may, for example, defer the purchase of depreciable assets until after the holiday has expired in order to enjoy the benefit of the tax write-off which the purchase generates. By denying the government tax revenue, these activities increase the (opportunity) cost of the scheme to the government. Secondly, applicants are required to submit information upon which they are to be assessed for approval. Since the punishment for misrepresentation is limited to withdrawing the holiday with retrospective effect, those firms that would not qualify if they revealed their information truthfully will have a positive expected return from misrepresentation (since the probability of the misrepresentation being discovered is less than 1). In this respect, the scheme violates the requirements of a direct revelation mechanism for which truth-telling is a dominant strategy. See Kreps (1990), pg. 697 for more on such mechanisms.

since the majority of the latter will have no international presence, whereas the former do by definition. Moreover, even if South African firms are holding companies for foreign subsidiaries, royalties, interest and dividends will ordinarily be paid by the subsidiaries to the South African holding company. Being income in the hands of the latter, they will also be tax exempt if a tax holiday is granted in South Africa. Therefore, the tax holiday will have no implication for the taxes that are payable in foreign hosts unless the funds flow *from* the home to the host country. Only in such cases will the tax saving in South Africa imply increased tax liability elsewhere for the South African TNC. For the most part, then, the full incidence of South African tax holidays is on the recipient firm when such firm is *South African* (even in the presence of a DTA).

In the previous section, we saw that this was not the case where the firm was *foreign* and where a DTA was in place. Since the number of countries with which South Africa has a DTA is significant, there is good reason to believe that tax holidays provide a weaker incentive for foreign firms than is the case for their local counterparts. We therefore have an objective basis for arguing in favour of a differentiated policy approach. If we recognise that tax holidays provide a relatively weaker incentive for foreign firms as a whole, two alternative responses suggest themselves. We may choose to provide relatively longer tax holidays to foreign firms or relatively shorter ones to local firms in order to generate an equally powerful inducement. Alternatively, recognition of the relative impotence of tax holidays in foreign investment decisions may lead us to abandon this particular scheme as an FDI policy but to retain it as an industrial policy.

In section 4.4 above, we also listed three conditions under which a segmented policy is justified. To recap, these conditions were the ability to identify (a) systematic differences in the value placed on a particular incentive policy, (b) systematic differences in the propensity to behave in the desired way in the absence of incentives, or (c) benefits that one group is more capable of producing than the other. The discussion above relates to point (a). We now wish to consider whether the adoption of a differentiated approach to tax holidays for foreign and domestic firms can also be justified on the grounds of point (b).⁷⁵

⁷⁵ Point (c) was mentioned in section 4.4 for the sake of completeness. We do not discuss it except in this footnote because it raises both formidable difficulties, and issues that are well beyond the scope of this study. Firstly, in order to ascertain whether systematic differences exist between the impact of FDI and domestic investment on the host, we need to understand, not only the impact that FDI tends to have on each

For all three components of the tax holiday scheme, there may be intuitive reasons to suspect that systematic differences between the effectiveness of these components for domestic firms and TNCs do exist.⁷⁶ To support this proposition, we begin by identifying reasons to suspect that TNCs as a whole and domestic firms as a whole differ in their propensity to invest in particular industries and geographic locations in response to the incentive.⁷⁷ This is the objective of the discussion to follow. Thereafter, we consider whether it is conceivable that the incentive necessary for foreign and domestic firms to comply with the human resource component differs between the two.

TNC's, by definition, have an international presence and have therefore indicated their preparedness to locate operations in foreign countries, should an opportunity present itself. They are therefore relatively more footloose than domestic firms as a whole.⁷⁸ We are not suggesting that there are no domestic firms with subsidiaries in foreign countries; but rather that, as a group, TNCs may be identified as being *relatively* more able/prepared to view foreign countries as alternative locations for direct investment than is the case for domestic firms as a whole. Since TNCs are more able to consider a number of possible host countries, they may be expected to be more sensitive to the general economic and political environment of the host than are domestic firms within that host. As a result, the decision of TNCs to invest is driven to a relatively greater extent by their overall assessment of the environment of the host relative to that of alternative destinations than is the case for domestic firms.⁷⁹

variable in the host economy, but the extent to which this differs from the impact of domestic investment. Secondly, where this analysis is based on historical data on the impact of FDI in that country, there is also a degree of circularity because this analysis is conducted in order to design appropriate policy, yet policy will impact on what such an analysis would have revealed. If the analysis is based on data from other countries, it will be extremely difficult to control for the impact of country specificities. These will substantially influence the impact of FDI on the economy, even if one is able to control for the policy environment. Thirdly, in the same way as FDI policy is able to influence TNC behaviour and its impact on the host, industrial policy is able to play a similar role for domestic investment. To determine whether systematic differences between FDI and domestic investment exist, we would therefore also require a comprehensive study of the efficacy of industrial policy in maximising the benefits from domestic investment. Finally, the issue is relatively less important from a policy point of view since the obvious response to the discovery of such a systematic difference is to try to allocate relatively more resources to attracting the type of investment that generates the greater benefit. We concluded in chapter 2 that this is not the appropriate focus of FDI policy.

⁷⁶ Which argument must ultimately be supported by the empirical evidence to be a valid assertion.

⁷⁷ Moreover, this argument will reinforce our earlier conclusion that investment incentives are relatively impotent in altering FDI flows. Our discussion here will compare the effectiveness of such policies on domestic and foreign investors.

⁷⁸ For arguments that support this assertion, see Agosin and Prieto (1993), pg. 80.

⁷⁹ This has been established in chapter 3 above.

There are a number of reasons that can be suggested as to why domestic firms may pay relatively less attention to investment opportunities in other countries. These include legal restrictions on foreign investment (such as exchange controls), the cost of gathering the information necessary to enter a foreign market and the possibility that their output may not be internationally competitive (and therefore requires the tariff protection provided by the home country). Whereas a TNC will consider investment opportunities both within and outside of South Africa, domestic firms are more likely to focus exclusively on investment opportunities within the country. Relative to TNCs, the choice set of domestic firms is therefore expected to be smaller. This, in turn, causes those factors that influence investment opportunities *within* the country to assume relatively greater importance for domestic firms.⁸⁰ Accordingly, we may expect investment incentives ("pre-entry conditions") to be *relatively* more capable of influencing the location of domestic investment. We may therefore expect the sectoral and spatial components of the tax holiday scheme to be more effective for domestic firms than their foreign counterparts.

Insofar as the human resource component of the tax holiday scheme is concerned, if we are able to identify reasons to suspect that TNCs and domestic firms differ in their propensity to have a high human resource remuneration to value added ratio, there is reason to adopt a differentiated policy approach. Once again, in the absence of the necessary empirical research, it is difficult to identify such a difference with any certainty. The following intuitions do, however, *suggest* that such differences *may* exist. Since TNCs typically hail from relatively more developed economies,⁸¹ the technology they introduce may tend to be more capital-intensive.⁸² *Ceteris paribus*, we may therefore expect that such technology would tend to lead to relatively lower human resource remuneration to value added ratios. If this is the case, we would need to offer TNCs greater incentives to induce them to increase this ratio to 55% than is the case for domestic firms that use relatively more labour-intensive production technologies.⁸³

⁸⁰ This reaffirms our conclusion in chapter 2 that investment incentives feature as a rather small influence on the investment decisions of TNCs.

⁸¹ See Kuper and Cassim (1996).

⁸² See Caves (1982) and section 3.1.2 above.

⁸³ This argument is indeed highly simplified as it has been discussed in abstract terms - it has not controlled for factors such as the economic sector in which the investment occurs, the reason underlying the decision to invest in this particular host (e.g. labour-seeking FDI) or the identity (and factor endowments) of the source country. In order to base policies on such differences in technology, the argument would need to be supported by empirical evidence that takes account of such factors. Our sole purpose in raising this point is to demonstrate that it is conceivable that systematic behavioural differences do exist. If empirical analysis is able to uncover these, policy efficiency may thereby be improved.

if we are correct in concluding that the efficacy of any of the components of the tax holiday scheme differs between domestic and foreign investors, it is recommended that a differentiated approach be adopted. If empirical studies confirm any of our intuitions that the holiday provides a relatively weaker incentive for foreign firms than for local firms (be it because of the value placed on the scheme as a whole is lower, or because the incentive that is necessary to alter TNC behaviour is greater), we may adopt one of the following approaches. Firstly, we may wish to ensure that the incentives offered to foreign and domestic investors are equally capable of altering behaviour in the desired direction. In this case, relatively greater incentives need to be provided to TNCs. Alternatively, by recognising the relative ineffectiveness of the scheme for FDI, we may decide to allow only domestic firms to apply for it, thereby allocating scarce government resources to where it will be most efficacious. If we still wish to promote the *objectives* of the tax holiday for foreign firms, we may replace the tax holiday with some other reward that will be valued more highly (e.g. a grant or subsidy) whilst imposing the same conditionalities as contained in the tax holiday scheme.

CHAPTER 6

SUMMARY AND CONCLUSION

The central objective of this paper has been to criticise the present policy stance towards FDI in South Africa. In order to do so, we have had to make the following logical progression. Firstly, we have had to determine what the appropriate role of FDI policy is. By considering the various influences on the locational decisions of TNCs, we have seen that investment incentives are unlikely to induce TNCs that would not otherwise have invested to do so, due to both the dominance of environment-specific considerations and the temporary nature of such incentives. Moreover, in those cases where these incentives do make the difference at the margin, there is the risk that the recipient will disinvest on termination of the incentives. We have thus arrived at ...

Proposition 1: Investment incentives are of minor importance in the investment decisions of TNCs. The resources utilised for investment incentives may thus be more effectively allocated elsewhere.

We therefore suggest a rather different focus for FDI policy, which we base on the following logical progression. Policies aimed at increasing FDI inflows are necessarily based on the premise that the overall impact of FDI on the host is positive. However, by analysing a variety of potential benefits from FDI, we discover that the extent to which these eventuate is substantially dependent on the behaviour of TNCs. Since it is the benefits that we seek, rather than FDI for its own sake, if FDI policy is able to encourage TNCs to behave in such a way as to promote the welfare of the host, there must certainly be significant gains therefrom. Such incentives would be unnecessary if the self-interested behaviour of the TNCs invariably promoted the welfare of the host. However, there are a number of respects in which the interests of TNCs and those of the host are in conflict. Therefore ...

Proposition 2: Once TNCs have invested, we cannot have a complete laissez faire approach since their emphasis is primarily on generating profits which often conflicts with the interests of the host. There may thus be substantial gains from policies able to align the interests of the TNC and the host.

We have therefore identified a preferable role for FDI policy, providing such policies are able to accomplish the abovementioned objective. In order to understand the nature of the problem of aligning conflicting interests with the use of incentives, we turned to the theory of moral hazard. This revealed that the problem is essentially one of asymmetric information in the presence of divergent interests. Although the formulation of the problem fitted neatly within the framework established by information economics, the solutions thereto could not be found easily within the theory due to a number of practical considerations. These complications were all essentially a function of informational problems over and above those of asymmetric information. Not only do we not possess the information required to specify the necessary functions, but the information contained in any relevant signal is almost negligible.

We discovered that it is these informational difficulties that lead policy makers to rely on simplified rules based on which policies may be implemented. This frequently involves targeting discernible groups and concentrating policy efforts on such groups based on generalisations as to the characteristics of its members. It is argued that, in the same way as it was pragmatic to target groups for policy purposes, it is incumbent upon us to attempt to identify whether there are not sub-groups that each have characteristics based upon which policy may be further segmented. Where this can be done, greater precision is likely to generate smaller economic rents and greater policy efficacy. We therefore have ...

Proposition 3: Due to insufficient information to implement incentive mechanisms optimally, we are forced to rely on simplified rules for policy that are less case-specific. The more simplified the rules, the greater the economic rents to recipient TNCs, thereby raising the cost of incentive mechanisms. Careful analysis and research is therefore essential to increase the precision of policy, and thereby reduce the costs and increase the effectiveness of such policies.

It is at this stage that we have completed establishing the basis upon which the South African stance towards FDI may be criticised. South Africa does have various incentive policies in place that target firms based on certain (simplified) criteria. If we are able to identify an instance in which policy efficacy could be improved by further differentiating between TNC and domestic investor recipients within these targeted groups, we will

have demonstrated that there may be gains to considering FDI separately from domestic investment for policy purposes. To this end, we take the example of the South African tax holiday scheme. We discover a number of intuitive reasons why various systematic differences in the impact of the scheme on domestic and foreign investors are likely to exist.

Proposition 4: There are a number of respects in which systematic differences between domestic and foreign investors are likely to exist. Its present policy stance denies South Africa the opportunity to increase the efficacy of its policy by taking cognisance of these differences.

The fact that South Africa has no distinct FDI policy, and has undertaken no empirical studies to reveal any systematic differences between local and foreign investors may therefore be criticised.

BIBLIOGRAPHY

- Agosin, Manuel R. and Prieto, F.J. (1993) ; "Trade and foreign direct investment policies: pieces of a new strategic approach to development ?" *Transnational Corporations*. Vol. 2 No. 2 63 - 86
- Bell, M. and Pavitt, K. (1992). "Accumulating Technological Capability in Developing Countries.", *Proceedings of the World Bank Annual Conference on Development Economics*.
- Bell, R.T. (1992); "Should South Africa Further its Foreign Trade ?" *Economic Trends Research Group, Working Paper no. 11*.
- Buckley, Peter J. and Casson, Mark. (1985) *The Economic Theory of the Multinational Enterprise. Selected papers*. London Macmillan.
- Business Map (1997). *South African Investment Report 1997*.
- Casson, Mark. (1986). *Multinationals and World Trade*
- Caves, Richard E. (1982) *Multinational Enterprise and Economic Analysis*, Cambridge Surveys of Economic Literature. Chapters 9, 10.
- Chang, Ha-Joon. (1996) *Globalisation, Transnational Corporations and Economic Development - Can the Developing Countries Pursue Strategic Industrial Policy in a Globalising World Economy?* [Paper presented at the Economic Policy Institute Conference on "Globalisation and Progressive Economic Policy"]
- Corden, W.M. (1994). *Economic Policy, Exchange Rates and the International System*. Oxford. Oxford University Press. Chapter 4.
- Cowling, K. and Sugden, R.. (1987) *Transnational Monopoly Capitalism* Brighton Wheatsheaf Books.
- Department of Finance, South Africa (1986), "Growth, Employment and Redistribution: A Macroeconomic Strategy."
- Dornbusch, R. and Fischer, S. (1991) "Moderate Inflation" *World Bank Discussion Paper*, Nov. 1991
- Dunning, John H. (Ed) (1985) *Multinational Enterprises, Economic Structure and International Competitiveness* Chapter 13. Chichester J. Wiley.
- _____ (1993) *Multinational Enterprises and the Global Economy*. Addison Wesley.

- Fedderke, J. (1997) "Political and Social Dimensions of Economic Growth" *Theoria*, June 1997.
- Finkelstein, S. And Hambrick, D. (1988) "Chief Executive Compensation: a Synthesis and Reconciliation" *Strategic Management Journal*, 9, 543-558.
- Fry, M. J. (1995) *Money, Interest and Banking in Economic Development*. Johns Hopkins University Press. Chapter 12.
- Garner, J. (1993) *Determinants of Recent Direct Investment Flows to South Africa*. London, Centre for the Study of the South African economy. Research Paper no. 8
- Guma, X.P. "The Revised Southern African Customs Union Agreement : An Appraisal" in *South African Journal of Economics*, 1990. pp 63-77
- Haugen, R. And Senbet, L. (1986) "The Role of Options in the Resolution of Agency Problems" *The Journal of Finance*, 41(5).
- Helleiner, Gerald K. (1989) "TNC's and DFI" In Chenery, H and Srinivasan (Eds) *Handbook in development economics*. North Holland. Ch 27
- Hirsch, A. (1991) "Industrial Development and the Spatial Economics of Apartheid" in Konczacki, Z.A., Parpart, J.L. and Shaw, T.M. (Eds.) *Studies in the economic history of Southern Africa*. Vol. 2. UK Frank Cass and Co. Limited.
- Hood, Neil and Young, Stephen (1979) *The Economics of Multinational Enterprise* London, Longman
- International Labour Office, Geneva. "Employment Effects of Multinational Enterprises in Developing Countries"
- Jensen, M and Meckling, W. (1976) "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*.
- Julius, DeAnne. (1990) *Global Companies and Public Policy: the Growing Challenge of Foreign Direct Investment*, Royal Institute of International Affairs.
- Kreps, D.M. (1990) "A Course in Microeconomic Theory" Harvester Wheatsheaf.
- Kuper, K and Cassim, R. (1996) *Global Economic Strategy Project*, Ch 5
- Lewellen, W., Loderer, C., Martin, K. And Blum, G. (1992) "Executive Compensation and the Performance of the Firm" *Managerial and Decision Economics*, 13, 65-74.
- Nelson, R. (1990). "On Technological Capabilities and Their Acquisition", in *Science and Technology: Lessons For Development Policy*, eds. Evenson, R. and Ranis, G. (USA: Westview Press Inc.).

Ozawa, T. (1992) "Foreign direct investment and economic development" *Transnational Corporations*, Vol. 1 no. 1, 27 - 54

Padayachee, V. (1995). "Foreign Capital and Economic Development in South Africa: Recent Trends and Postapartheid Prospects" *World Development*, Vol. 23 no. 2.

Paterson, S. and Simkins, P. (Eds.) (1997). "Doing Business in South Africa" - Document published by Price Waterhouse and Deneys Reitz, South Africa.

Perez, C. (1988). "New Technologies and Development," in Freeman, C. and Lundvall, B., op. Cit.

Perez, C. and Soete, L. (1988). "Catching up in Technology: Entry Barriers and Windows of Opportunity," in Dosi et al., op. cit.

Reidel, J. (1987). Myths and realities of external constraints on development. Thames essays, Trade Policy Research Centre. Ch 4

Revenue Laws Amendment Act No. 46, 1996. Government Gazette, 30 September, 1996.

Robinson, R.D. *National Control of Foreign Business Entry : A Survey of Fifteen Countries*. Chapter 11.

Stiglitz, J. (1988) "Economics of the Public Sector". Norton.

Strydom, P.D.F. (1995) *International Capital Flows*, Cape Town, AIPA, Unpublished Manuscript.

Todaro, M.P. *Economic Development in the Third World*, Fourth Edition. Ch 14, 15, 17.

Tzur, J. and Yaari, V. (1994) "Management's reporting Strategy and Imperfection of the Capital Market" *Managerial and Decision Economics*, 15.

Wood, E. and Moll, T. (1994) "Capital Flight in South Africa : Is Underinvoicing Exaggerated?" in *South African Journal of Economics*, pp 28-45

Zainuddin, D. (1993). "Foreign direct investment and experiences of Malaysia and other high growth Asian economies" in Baker, P et al. (Eds) *South Africa and the world economy in the 1990's*. Cape Town, David Philip Publishers.

Author: Cohen, Richard.

Name of thesis: Should South Africa have an FDI policy- - a critical analysis of South Africa's current policy stance.

PUBLISHER:

University of the Witwatersrand, Johannesburg

©2015

LEGALNOTICES:

Copyright Notice: All materials on the University of the Witwatersrand, Johannesburg Library website are protected by South African copyright law and may not be distributed, transmitted, displayed or otherwise published in any format, without the prior written permission of the copyright owner.

Disclaimer and Terms of Use: Provided that you maintain all copyright and other notices contained therein, you may download material (one machine readable copy and one print copy per page) for your personal and/or educational non-commercial use only.

The University of the Witwatersrand, Johannesburg, is not responsible for any errors or omissions and excludes any and all liability for any errors in or omissions from the information on the Library website.