

**THE DETERMINANTS OF FDI AND SOUTH AFRICA'S  
INDUSTRIAL DEVELOPMENT STRATEGY:  
TOWARDS A RESEARCH AGENDA**

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## Introduction

Despite criticism<sup>1</sup> of some of the empirical and theoretical arguments behind the Growth, Employment and Redistribution Strategy<sup>2</sup> released by government in 1996, this plan continues to be used as the starting point for development policy formulation. The research underpinning this paper, was stimulated by the approach to foreign direct investment (FDI) in GEAR. FDI emerges from this strategy as a saviour. This implies that government has accepted the argument that inward FDI can facilitate development in South Africa (SA) and that the success of our development plan rests heavily upon an assumption that large inflows of FDI **will** be forthcoming. The reliance on FDI as a catalyst for development, raises the following questions. What, according to government's development vision, are the most significant determinants of FDI and policies that will generate a surge in inward FDI? How credible is this approach in the light of FDI theory and empirical evidence on FDI determinants? What kind of research is needed to enhance our understanding of FDI determinants in SA and to improve the potential effectiveness of policies aimed at raising SA's attractiveness as an investment location? This paper has two aims. The first, it to offer some tentative answers to these questions. The second is to draw on the response generated by this paper to develop a strategy for research to produce more informed and persuasive answers to these questions.

The paper is divided into five sections. Section one defines FDI, presents government's projections for new FDI and data on recent FDI in SA. Section two identifies the role of FDI in SA's current development strategy, outlines the understanding of FDI determinants implicit in it and describes the policies being put in place to attract FDI. Section three presents a thumbnail sketch of the evolution of ideas in economic theory on the determinants of FDI. Section four draws out the important points that emerge from our cursory investigation of the theory of FDI in conjunction with the empirical evidence on the determinants of FDI. The conclusion comments on the implications of the analysis for current FDI and development prospects and policy in SA and then concentrates on drawing out the implications for research.

### 1. Defining FDI and the GEAR FDI projections against recent FDI into SA

'...it is in the nature of FDI that statistical information on it cannot be comprehensive enough to allow fine analytical experiments' (Agarwal, 1980:763).

The definition of FDI, used by governments to compile balance of payments (BOPs) statistics, is that in the IMF's *Balance of Payments Manual* (1993:86): 'Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy...(it)...comprises not only the initial transaction...but also all subsequent transactions between the...affiliated enterprises'. This definition divides FDI into equity capital, reinvested earnings, and other capital associated with intercompany debt transactions. FDI is distinguished from portfolio investment by the 'influence that gives the

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<sup>1</sup> See COSATU (1996), chapter two in Standing et al. (1996), Adelzadeh (1996), and Pillay (1996).

<sup>2</sup> Henceforth referred to as GEAR.

(direct) investor an effective voice in management' (Ibid)<sup>3</sup>. For two reasons, the IMF definition is too narrow. It suggests that FDI **always** involves the international transfer of money capital, when all the capital used by an investor to buy control over the direct investment enterprise can be raised in the host country. Second, it defines FDI flows **only** as money capital when it incorporates the transfer of other income generating assets<sup>4</sup>. Historically, the Multinational Corporation (MNC) has been the main vehicle for FDI.

The MNC is commonly defined as an enterprise which controls and manages assets in at least two countries (Helleiner, 1989:1442). MNCs can be divided into three types. One turns out essentially the same lines of goods or services from each facility in several locations, and is called the horizontally integrated MNC. Another, the vertically integrated MNC, produces outputs in some facilities which serve as inputs into other facilities located across national boundaries. The third is the internationally diversified MNC, whose plants' outputs are neither vertically nor horizontally related (Teece, 1985:233; Caves, 1996:2). We see and define FDI as 'a packaged transfer of capital, technology, management and other skills, which takes place internally within MNCs' (Buckley and Brooke, 1992:249)<sup>5</sup>.

Despite the measurement and conceptual deficiencies behind official inward FDI data, we present the most recent data available for SA below, together with GEAR's inward FDI forecast. Three important points emerge from it.

**Table I: GEAR's Integrated Scenario Projections for inward FDI**

Additional FDI (US\$m)	1996	1997	1998	1999	2000
	155	365	504	716	804

Source: GEAR, 1996:7.

**Table II: SARB data on the direct investment component of private capital movements, 1990-1996, R millions (a)**

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<sup>3</sup> Investors acquire 'control' if they obtain 10% or more of the voting stock of the direct investment enterprise. It is difficult to define 'control' so countries differ in regard to the minimum percentage of equity ownership that they count as 'direct' as opposed to 'portfolio' investment. (Caves, 1996:1).

<sup>4</sup> In Kojima's words (1973:1) 'the essence of FDI is the transmission to the host country of a package of capital, managerial skills, and technical knowledge'. Or, as Sodersten et.al. (1994:470) stress '...capital...is only the complementary factor in a direct investment. The central element of FDI is that it consists of a package of capital, knowledge, skills, etc'.

<sup>5</sup> Each element of the package can of course be transferred separately by markets: Capital can be loaned, technology sold through licensing agreements and skills can be contracted out. These unbundled resources can then be put together in the host country under domestic control. These market relationships represent the major alternatives to FDI as a means of international transfer of resources. As we will see in section 4, inter-firm alliances have become increasingly important with the implication that these alternative forms of transfer are increasing.

	1990	1991	1992	1993	1994	1995	1996
Foreign liabilities (b)							
Long-term dir. invest.	242	219	77	219	48	2 646	2 617
Short-term dir. invest.	-478	367	-196	-282	1 153	912	650
<b>Total foreign liabilities</b>	<b>-236</b>	<b>586</b>	<b>-119</b>	<b>- 63</b>	<b>1 201</b>	<b>3 558</b>	<b>3 267</b>
Foreign assets (c)							
Long-term dir. invest.	-166	-755	-1824	-781	-402	59	-30
Short-term dir. invest.	95	181	- 348	-142	-105	-1 041	-215
Total foreign assets	- 71	-574	-2172	-923	-507	-2 038	-245
Total net identified movements in direct investment capital	- 307	12	-2292	-986	694	1 520	3 022

- Notes: a) The SARB uses the IMF definition: Direct investment refers to a. the investment of foreigners in undertakings in SA in which they have individually or collectively at least 10% of the voting rights or b. the investment of South African residents in undertakings abroad in which they have at least 10% of the voting stock.
- b) An inflow of capital, shown as a positive amount, indicates an increase in foreign liabilities, while an outflow, shown as a negative amount, indicates a decrease.
- c) An inflow of capital, shown as a positive amount, represents a decrease in foreign assets, while an outflow, shown as a negative amount, indicates an increase.

Source: SARB *Quarterly Bulletin*, March 1998, compiled from S-83.

First, we see that FDI has played an increasingly important role in the economy since 1994. Inward FDI turned positive and increased rapidly between 1994 and 1996. 1997 continued to witness this favourable turnaround in FDI. (IMF, December 1997:630-631; Craig, 1998). Due partly to the completion of the first privatisation transaction involving foreign participation - the sale of a 30% equity interest in Telkom to a consortium of non-resident (USA and Malaysian) companies - the second quarter of 1997 witnessed a particularly large inflow of FDI. Investment Southern Africa (ISA) estimates that 955 MNCs now own stakes in 2 050 entities in SA which manage 380 000 employees and control about \$44.8 billion in assets. (Craig, 1998:20-21). However and second, this turn around in inward FDI is not surprising. SA's L advantages were hardly exploited during the 1980s and early 1990s, so that the post-apartheid economy had a latent potential to attract FDI. The increase that has occurred thus probably says little about the impact of economic policy and more about the return of investors that disinvested due to sanctions and the response

to Telkom's privatization<sup>6</sup>. Finally, even though the economy may have thus far been more than able to attract the quantity of FDI demanded by GEAR, this does not imply that the GEAR projections for 1998-2000 are within reach and that we should expect continued increases in inward FDI. In the March (1998:2) *Quarterly Economic Review*, the SARB Governor warned policy makers not to rely heavily on large quantities of new FDI because 'foreign direct investors...still seem somewhat hesitant to commit large amounts of capital, probably due to uncertainty over exchange rate movements, a mismatch between productivity and remuneration levels and concerns over violent crime'.

Why are large increases in inward FDI being seen as so important for development in SA? Why are policy makers confident they will come? What is the strategy to attract FDI and on what understanding of FDI determinants does it rest?

## **2. The role and determinants of FDI in SA's current development strategy**

### **2.1 FDI as a vehicle for bypassing the foreign exchange constraint**

As has been explained many times<sup>7</sup> the success of the GEAR strategy rests upon a rapid expansion of non-gold exports and increases in (primarily private sector) investment. A consideration of the sources of savings needed to finance increased investment and plan to ease what is viewed as the binding constraint on growth, show that new FDI is also essential. In fact, it suggests that FDI is one of two main engines in the development plan. Gross domestic saving has to rise from 18% to 22% of GDP by the year 2000, whilst gross domestic investment has to increase from 20% to nearly 26% of GDP. (Ibid:5-6). 'This requires capital inflows equivalent to almost 4% of GDP'(Ibid:6) and, as revealed in Table I, that inward FDI rises by more than five times the 1994 level. In the context of a low savings rate, GEAR presents the BOPs as the primary constraint on growth and stagnant inward FDI flows as the core reason why policy makers have had to resort to high interest rates: 'The BOPs remains a...barrier to accelerated growth...the upswing brings a deterioration in the current account...the lack of sustained long term capital inflows has made the...economy too reliant on short term reversible flows and consequently high interest rates' (GEAR:3). An increase in direct relative to portfolio investment is seen by policy makers as crucial for creating an environment in which we can rely less on volatile

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<sup>6</sup> BusinessMap data on FDI into SA post April 1994, supports this assertion. American MNCs disinvested most in the 1980s. The USA emerges as the largest direct investor in SA since 1994. A large proportion of the new investment by US firms is reinvestment. (BusinessMap, 1997:7).

<sup>7</sup> See GEAR (1996), Natrass (1996 and 1997), Standing et.al (1996) and Adelzadeh (1996).

portfolio inflows to 'facilitate growth' and in which interest rates can be lowered to encourage domestic investment (Adelzadeh, 1996:73).

The importance of inward FDI, and exports - the other growth engine - is thus made clear by the immediate foreign exchange constraint. FDI is however, not only desired for its capacity to have a once off positive effect on the capital account. Government is particularly keen on attracting export-oriented manufacturing FDI (GEAR, Appendix 12 and South African Government, 1998) and wants to use the non-money components of the FDI package and competitive pressures associated with FDI, to stimulate innovation and exports in local firms. (GEAR, 1996:6 and appendix 12; Donaldson, 1997:455). Inward FDI is thus also seen as one of the means to improve current account performance.

## **2.2 The strategy to attract FDI and what it assumes about FDI determinants**

Policy makers seem to be of the opinion that foreign direct investors want the following in SA: i. 'sound'/austere macroeconomic policy; ii. deregulation of markets and investment; and iii. supply side policies which reduce unit costs and raise productivity and EPZs (GEAR, 1996).

Implicit in the GEAR interpretation of investor expectations is that investors see 'sound' as 'austere' macroeconomic policy: the deficit should be 3% of GDP by 2000 (GEAR, 1996:7-8) and monetary policy must maintain an inflation rate of 7% (Ibid:10 and appendix 12). Deregulation and liberalization involve freeing the international arena from controls (dropping exchange controls, relaxing direct investors' access to domestic credit<sup>8</sup> and further tariff reductions), privatization, enhancing labour market flexibility, integration of the SADC economies, and limiting government investment in the economy to public goods<sup>9</sup>.

The supply side measures to attract FDI are a product of the shift in industrial policy away from subsidies and tariffs (that gave investors protected markets), towards a greater reliance on market-led support measures. (Hirsch, 1996:7; GEAR, 1996:11). The supply

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<sup>8</sup> In terms of the new regulations, a non-resident owned entity must be able to borrow '100% of share-holders' equity' (GEAR, 1996:11). This seems odd in light of the plan to use FDI to overcome the immediate foreign exchange constraint. Even though empirical evidence suggests that efficiency seeking are less likely than market seeking direct investors to raise their finance locally (Caves, 1996:218), MNCs do still finance some of their host-country operations in host-country capital markets. (Teece, 1985:233).

<sup>9</sup> Even here, 'private sector involvement is to be as extensive as possible, due to the commitment to reducing government dissaving and the realisation that the capacity of the civil service is extremely limited' (Cargill 1997:36).

side industrial support measures are still evolving. (Cargill, 1997:38). They can be grouped into: i. tariff reductions, tax holidays and depreciation allowances to reduce investors' input costs; and ii. technology and human resource development incentives to raise the value of factors (Hirsch, 1997:8-9; Cargill, 1997:35-37). The features of the package of incentives that ISA is marketing and government is hoping will entice MNCs into SA, are being influenced by the Spatial Development Initiatives (SDI), Industrial Development Zones (IDZ), and Cluster Studies (CS). The CS are aimed at facilitating complementary investments in sectors (ie stimulating external economies<sup>10</sup>). (DTI, 1998:3). The principle mechanism underpinning the SDI is private investment which is to be 'crowded-in' through public sector financial support for infrastructural and anchor projects. The IDZs aim to encourage export oriented manufacturing FDI (and local investment) by giving investors: duty free status for imported raw materials; tax incentives; easy access to an airport and port; world class infrastructure and services; the latest information technology; and first class IDZ management. (South African Government, 1997:1). It is not yet clear how the 'IDZ' will differ from the typical 'EPZ' used in other developing countries to attract FDI<sup>11</sup> but it seems as if exemption from labour market legislation is not contemplated. (Kaplan and Bloch, 1997:15).

Two features of the emerging industrial and FDI strategy need to be highlighted. First, the limited level of government investment envisaged in the strategy. Most of the costs of the CS are to be shared between industry players although 'some supply-side measures in the DTI support cluster activities' (Ibid:5). The success of the SDI and IDZ is also being left up to private financiers: whilst government has been involved in deciding on anchor projects and investing in some infrastructure, the target ratio of government to private investment is only 10:90 for the SDIs (Hirsch, 1997:8; Lewis and Bloch, 1997:14). This once again highlights the extent to which outside knowledge and capital, to be delivered by MNCs, are being relied upon to build new L advantages in SA. Second, despite the regional targeting implied in the SDI and industry specific support for innovation and R&D envisaged in the Science and Technology White Paper (1996), the industrial policy is largely neo-liberal in nature. Supply side interventions are primarily functional and there is no long term vision outlining how government plans to coordinate, encourage and steer investment into particular skills, technologies and industries in order to build new L

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<sup>10</sup> 'Competitive advantage is not created within a single firm alone. Efficiency in internal operations is essential but not...sufficient to compete globally. Factors external to the business are increasingly important. Each firm is inherently part of a 'cluster' of activities made up of firms along the value chain as well as related and supporting organisations (eg. R&D, finance, skills, infrastructure). (DTI, 1998:3).

<sup>11</sup> These zones are usually a device for bundling together concessions from the host country's prevailing taxes, tariffs and labour regulations. (Caves, 1996:220).

advantages and enhance SAs ability to export higher value added goods<sup>12</sup>.

To summarize, the `right' policies are seen as necessary for a surge in inward FDI. These are the ones summarized in the Washington Consensus: favourable investment expectations have been linked to austere macroeconomic policy and a minimalist allocative role for the state, not evidence of factor input upgrading and/or sustainable growth. The story about L advantages and how to attract FDI into SA goes as follows: As long as government remains committed to austere macroeconomic policies, invests a little (and encourages private agents to invest a lot) in the infrastructure, skills and technologies required for successful clusters and IDZs, and aggressively markets SA as an attractive location (making it clear that it will not interfere with MNCs decisions), L advantages in the form of commitment to these policies and supply side incentives (particularly trade and tax incentives) **will** attract MNCs as a large private sector response to the incentive programme enhances productivity and generates booming industrial districts.

The reliance on FDI to build the L advantages required for more FDI and industrial transformation, suggests that unless FDI is very responsive to credible policies of the neo-liberal variety and/or SA has excellent L advantages in the form of efficient inputs and factors of production, the FDI and development plan may flounder due to lack of a catalyst. Without even considering the theory and empirical evidence on FDI determinants, the **certainty** about how foreign direct investors **will** respond to the `right' policies seems to lack credibility. Surely the inherent subjectivism of investment expectations makes them difficult to understand and impossible to predict (Schackle, 1989). Moreover, there is no consensus over the type of policies required for FDI and industrialization: `...there is no wisdom on economic development, and there are no wise men...Economists do not all `know' the same things. What is `known' to be true by most (the orthodoxy of the moment) has moved a lot in one century' (Krugman, 1995:717&732). Although neo-liberal ideas are still dominant in economics, they have been coming under attack. The counter-counterrevolution in economics on the role of the state in development, has ensured that the revisionist argument (that speedy development depends upon an efficient state acting as an entrepreneur, institution builder and investor, and implementing an integrated set of industrial and technology policies based on a vision of current L/competitive advantages and how they need to be upgraded) has gained ground. (See references in previous footnote).

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<sup>12</sup> For the distinction between functional and selective intervention, definition of neo-liberal industrial policy and a critique of this strategy, see Lall (various), Amsden (1994) and Chang and Rowthorn (1995).



The deterministic stance to FDI implicit in the new industrialization strategy, is also surprising when read with appendix 12 of GEAR. This emphasises **economic growth** 'as a powerful stimulus of FDI' and says that:

'Increasing FDI requires paying attention to the fundamental determinants of international investment decisions and the underlying macroeconomic expectations which **may** be relevant. These, **might** include: political and economic stability, including macroeconomic **stability** and **clarity** about economic policy; sustained high rates of **economic growth**; labour market stability and flexibility; investment incentives; the tariff regime; protection of property rights; and **various** determinants of expected investment returns'.

The understanding of FDI determinants which underpins GEAR and the new industrial policy, is supported by the World Bank and IMF (see World Bank, 1997). As Krugman (1995:724-725) warns in his review of the methodology behind cycles of 'wisdom' in economics, the level of acceptance of a 'conventional wisdom' may not be an indication of the degree to which theoretical insights and empirical evidence inform it. What insights emerge from economic theory and history on the 'fundamental determinants of international investment decisions'?

### **3. Ideas in economic theory on the determinants of FDI**

#### **3.1 The inability of the perfectly competitive framework to understand FDI**

The assumption of internationally immobile factors prevented classical theory from producing insights on FDI determinants. Explaining FDI was also beyond early neoclassical trade theory. This was not only due to the immobile factor assumption. FDI implies that a foreign firm possesses resource endowments<sup>13</sup> not available to another country's enterprises. Therefore, in the perfectly competitive models of early trade theory, FDI could by definition, not exist. (Hirsch, 1976:258-259). Models which dropped the assumption of immobile capital under perfect competition did emerge. By replacing the assumption of factor with goods immobility using the Heckscher-Ohlin framework, it was argued that movements in factors also respond to differential resource endowments. Trade in capital and goods became substitutes. These ideas were formally integrated into the

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<sup>13</sup> We use 'resource endowments' to mean assets capable of generating a future income stream. They include tangible assets and intangible assets. Such endowments can be location specific to the home country, or ownership specific, that is, internal to the enterprise of the home country, but capable of being used with other resources in the home country or elsewhere. (Johnson, 1968, cited in Dunning, 1981a:25).

factor price equalisation theorem by Samuelson (1948) and Mundell (1957). But, because of perfect competition, these models could not shed light on the determinants of FDI (as opposed to portfolio investment). The only suggestion to emerge from them was that government imposed distortions (eg tariffs), could produce a motive for FDI. This 'insight' was problematic because the models could not logically explain how foreign firms could out compete local ones. Dunning and Rugman (1985:228) elegantly explain how early theory failed to deal with FDI.

'The explanation of international capital movements relied exclusively upon the neoclassical financial theory of portfolio flows...capital was assumed to be transacted between independent buyers and sellers...there was no role for the MNC...and no separate theory of FDI. The work did not even ask...why is there FDI?'

Despite the rising role of FDI in the global economy from the turn of the 20th century, it was only after the unprecedented surge in FDI during the 1950s, that economists became sufficiently interested in the role of MNCs in orchestrating capital flows to begin developing a separate theory of FDI.

### **3.2 The modern theory of FDI: FDI determinants in an imperfectly competitive world**

Hymer is the innovator behind the modern theory of FDI. In his PhD thesis, he explained why an understanding of FDI required a paradigm shift: away from the portfolio theory of capital movements, towards the application of industrial organisation theory to international production. Hymer's first contribution was to focus attention upon the MNC: After Hymer's thesis, it was accepted that the theory of FDI is primarily about transfers of non-financial and ownership specific intangible assets by **MNCs**, which need to appropriate and control the use of these assets (Dunning and Rugman, 1985:228). Hymer found a positive association between oligopolistic market structures and FDI by US firms. This led him to conclude that competitive conditions influence FDI and that firm specific ownership (O) advantages had something to do with FDI (Dunning, 1981a:23). The significance of Hymer's thesis flowed from the simple proposition that in order to compete with indigenous firms which possess innate strengths such as knowledge of the local environment, foreign entrants must have some compensating advantage. Hymer's O advantages included scale economies, access to distribution networks, knowledge and other first mover advantages, and imperfections in input markets (Teece, 1985:234; Dunning and Rugman, 1985:229).

Imperfect competition and O advantages are necessary to explain FDI, but are not

sufficient. One needs to explain why a firm will choose to exploit an O advantage by FDI rather than exports or licensing. According to Hymer, control of a foreign subsidiary was desired primarily to remove competition: FDI is a means to exploit an O advantage which emerges from structural market imperfections and which eliminates competition both at home and abroad (Rugman and Dunning, 1985:229). Whilst Hymer focused on oligopolists' attempts to defend market shares, he did mention tariffs as a factor influencing the choice between FDI and exports. He also suggested that failures in the firm's intermediate markets may cause FDI to be favoured over licensing. (Buckley and Brooke, 1992:56-57; Agarwal, 1980:747-748). Following Hymer's contribution, the development of the theory of FDI determinants can be divided into four phases (Buckley and Brooke, 1992; Brewer, 1993).

First, studies emerged which extended Hymer's notions of O advantages and that FDI results from action to prevent loss of market share. Kindleberger (1969) identified four O advantages. (See Agarwal, 1980:749). Caves (1971) argued that the critical advantage was product differentiation. He also pointed out that O advantages will vary according to whether FDI is carried out by horizontally or vertically integrated MNCs. (Buckley and Brooke, 1992:57). Johnson (1970 and 1975) reasoned that the significant advantage must be capable of being exploited by a subsidiary at a cost that is low in relation to the acquisition costs facing a rival firm. This led him to emphasize knowledge. (Ibid). Aliber (1970) argued that the crucial advantage was derived from imperfections in capital markets. His story is that firms in the parent country are able to finance their activities more profitably than host country firms because they can borrow at a lower rate from the international capital market. This is because a factor determining the interest rate on loans is the risk associated with depreciation of the currency in which the debt is held; and when MNCs borrow funds, the loans are held in parent country currencies (Agarwal, 1980:757-758)<sup>14</sup>. Knickerbocker's (1973) study of US MNCs led him to support Hymer's notion of FDI as a result of oligopolistic reaction to defend market share<sup>15</sup> (Ibid).

Second, Vernon (1966, 1979) contributed to the literature with his product cycle theory. In this, the significant O advantage is technology. In anticipation of the eclectic theory of FDI, Vernon integrated the O advantage 'explanation' of FDI with one based on two L factors:

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<sup>14</sup> This hypothesis gained wide acceptance, partly because of the surge in FDI from the US in the post WWII period and from Japan in the 1970s and 80s. It is however, of limited value because: i. empirical studies show that the exchange rate is only one of many factors influencing FDI decisions; ii. it fails to explain the rise in outward FDI from the US and UK in the late 1970s and early 80s, when these countries' currencies were weak; iii. it cannot explain the extensive FDI between countries within the same currency area or FDI from developing countries, which has grown significantly since the 1970s.

<sup>15</sup> This thesis does not explain what sets the ball rolling.

demand (linked to changes in taste as per capita income increases) and labour costs<sup>16</sup>. The product life cycle theory is essentially an analytical synthesis of change in both O and L advantages for a firm growing through oligopolistic behaviour. (Lumby, 1988:117).

The third major development in the theory resulted from the application of Coase and Williamson's theory of the firm to international markets<sup>17</sup>. It produced the story that the MNC and FDI are the result of transaction costs and internalization (I) advantages that make trade and licensing uneconomic relative to FDI. In the internalisation perspective:

'FDI occurs in consequence of transaction costs, risks and uncertainties in arm's-length markets, and the potential for increased control, improved deployment of market power, reduced uncertainty, scale and scope economies, and advantageous transfer pricing in internalized systems. Internalization...is a means of overcoming market imperfections - generated by national boundaries, informational deficiencies, and the like - and, via the creation of internal markets, contributes to worldwide efficiency' (Helleiner, 1989:1452).

For a list of the most common I advantages and transaction cost that have been identified as determinants of FDI, see Table Aii in appendix A and Rugman (1980). According to Rugman (1980:376), the internalisation theorists provides us with a general theory of FDI.

'The process of internalization explains most (and probably all) of the reasons for FDI. Previous writers on the motives for FDI have tended to identify one or more of the imperfections in...markets, or have noticed a response by the MNE to government induced imperfections such as tariffs...All of these imperfections serve to stimulate one sort of MNE or another. The MNE is in the business of internalizing externalities. It is now time to recognize that internalization is a general theory of FDI'.

To operationalise the very general internalization theory, detailed information about the nature of transaction costs and country specific factors is needed. The fourth phase in the development of the theory of FDI was ushered in when Dunning put forward his 'eclectic paradigm' at a 1976 Nobel Symposium. The development of the paradigm was driven by a desire to: i. classify the most common determinants behind FDI (into OLI determinants);

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<sup>16</sup> Vernon's original model focused on FDI by MNCs from the US and on labour costs as the L factor attracting FDI to developing countries once the technology embodied in a product had reached maturity. The scope of the product cycle hypothesis has been widened several times so that it now takes into account other factor costs. (Agarwal 1980:751). Hirsch (1976) also developed a model which focused on the choice between FDI and exports. It explains the choice as influenced by the high fixed costs associated with FDI and the high variable costs associated with exports. After a critical level of demand in the host country has been reached, variable costs become smaller than fixed costs and the firm switches to FDI.

<sup>17</sup> For this literature see: Dunning (1973&1981a); Casson (1985); Rugman (1980); and Caves (1996).

ii. integrate the ideas that had emerged by the 1970s into a general theory of FDI, licensing and exports; iii. ensure that O advantages remained endogenous in the theory of FDI; and iv. pay more attention to the influence of L factors in the international production decision<sup>18</sup>. Whilst the eclectic theory did not produce any new theoretical insights or formal models, it has at least provided us with a more holistic (if simple and very general) paradigm to use in our attempt to understand the factors behind the level and pattern of FDI into and out of real economies<sup>19</sup>.

The eclectic theory says that a firm will engage in FDI when three conditions are satisfied:

- i. The firm has some O advantages in operating in particular foreign markets that allow it to compete in those markets vis-a-vis other, and in particular indigenous firms.
- ii. The firm believes that these O advantages can be best exploited internally rather than transacted directly through spot markets or offered to other firms by means of non-equity arrangements, e.g.licensing agreements or management contracts.
- iii. There are L attractions of a foreign as compared to domestic production base in the manufacture of all or part of the product(s) of the firm. This ensures that the enterprise will be encouraged to utilise these advantages in conjunction with at least some factor inputs (including natural resources) outside its home country; otherwise foreign markets would be served by exports. (Dunning, 1981a:79; Norman and Dunning, 1984:523).

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<sup>18</sup> Our sketch of the development of FDI theory between 1960 and 80 suggests that aside from Vernon's work, little attention was paid to L factors. The internalisation theory does however, implicitly deal with the question by arguing that L factors affect I advantages (see Rugman 1980 and 1985 for examples of how L factors can be incorporated into the internalization theory). Survey work had also shed light on the 'where' issue.

<sup>19</sup> Some of the internalization theorists do not share this view. They complain that: i. it is double counting to use both O and I advantages because the very act of internalizing a market gives the firm an advantage; ii. in certain cases - for example FDI influenced by the costs imposed by a tariff - it is double counting to use both L and I advantages. They conclude that there is no need for the eclectic theory - the internalization theory is sufficient.

**Table III: Alternative Routes of Servicing Foreign Markets**

		Advantages		
		ownership	internalisation	location
Route of servicing market	FDI	yes	yes	yes
	Exports	yes	yes	no
	Licensing	yes	no	no

Source: Dunning, 1981b:33.

The OLI paradigm leaves much room for disagreement and further analysis concerning the OLI advantages behind FDI. (Helleiner, 1989:1453). It is now the theoretical toolkit which is most commonly used to conduct empirical studies aimed at gaining a better understanding of FDI determinants.

#### **4. Insights from the theory of FDI and empirical work on FDI determinants**

Five insights into the determinants of FDI relevant for assessing the credibility of current policies aimed at attracting FDI into SA and research directed at improving the design of these policies, emerge from reading the studies aimed at giving empirical content to the eclectic paradigm.

The first is that it is not useful to think about 'the' determinants of FDI<sup>20</sup>. 'The' OLI determinants behind FDI vary across industries and countries and according to which MNC is investing. (Dunning, 1981a&b, 1995 and 1998; Buckley and Brooke, 1992; Caves, 1996). Because we are concerned about how the South African government can attract FDI, we are mostly interested in the L factors that seem to have been driving FDI into developing countries in general and SA in particular. Empirical work has made it clear that whilst a couple of L determinants are generic (see below), the relative importance of the various L factors, is country and industry specific. This implies that industry and country specific studies are required for a rigorous understanding of FDI determinants and effective FDI policy design.

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<sup>20</sup> Thus, Helleiner argues (1989:1447): 'there is a need to deal separately with the determinants of FDI oriented to export, local and common markets and that if the determinants of FDI are influenced by industry and country specific factors, it may be productive to consider transnational activity as taking place in a variety of different markets for it'. And, Dunning (1981b:33) explains that although the eclectic model is a general theory in so far as it provides an analytical framework for explaining all forms of such production this is not to assert that all types are to be explained by the same OLI characteristics.

Whilst the literature makes it clear that it is dangerous to aggregate, it suggests that classifying FDI into four types - efficiency<sup>21</sup>, market<sup>22</sup>, natural resource and strategic asset seeking<sup>23</sup> - can facilitate understanding. This classification is based on how motives and OLI determinants vary across types. We would expect market seeking FDI, which is predominantly carried out by horizontally integrated MNCs and import substituting<sup>24</sup>, to be influenced primarily by the following L advantages: size, structure and growth of local and common markets, economies of scale, host government policy towards imports, transport costs, and political and economic stability in the potential host country relative to other similar countries in close proximity. We would expect that resource and efficiency seeking FDI would be pulled into countries more by the availability and cost of natural resources and labour, the productivity and skills of human resources, the extent and quality of local technological and communications infrastructure, the efficiency of government institutions, external economies generated by industrial districts, the value of the exchange rate, proximity to leading export markets, the extent to which trade (including trade in intermediary products) is free between home and host countries, and between host countries in which foreign affiliates of MNCs are located (ie cost of imported inputs) and perhaps, taxes and other incentives. For asset seeking FDI, we would expect the host country's created assets, including the innovatory capacity of firms, to be the crucial L factor. The empirical work on the determinants of FDI in developing countries suggests that these expectations about how the relative importance of L determinants differs across types, is correct. See Reuber (1973), Agarwal, (1980), Majumdar (1980), Dunning, (1981a and 1998), Moran and Contributors (1986), Jeon (1992), United Nations (1993), Meyer and QU (1995) and Caves (1996). The distinction between the L determinants of different types of FDI must be seen by policy makers and researchers.

To our knowledge, no application of the OLI paradigm using SA FDI data, has been

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<sup>21</sup> This refers to FDI aimed at increasing the efficiency of MNC activities by integrating assets, production and markets. It is often lumped together with resource seeking FDI and called cost or export oriented FDI.

<sup>22</sup> FDI in services - a rapidly growing phenomenon including in SA - falls into this category, as services have to be performed *in situ*.

<sup>23</sup> This refers to FDI which is driven by the attempt to acquire resources and capabilities that an investing firm believes will sustain or enhance its core competencies in regional or global markets. These assets may range from innovatory capability and organisational structures to accessing foreign distribution channels and a better appreciation of the needs of consumers in unfamiliar markets. (Chudnovsky, 1997:174).

<sup>24</sup> As Caves (1996:18) points out, we must not however, see the distinction between import substituting FDI by horizontally integrated MNCs and export oriented FDI by vertically integrated MNCs as always being operational. Some trade in goods - although not a significant amount - is usually associated with the horizontally integrated MNC: 'Many...(horizontal)...subsidiaries do not just produce their parents' goods for the local market; they process semifinished goods, or package them according to local specifications'. This further emphasizes that we should not see trade and FDI as substitutes.

conducted. Without more research, it is difficult to make statements about what the most L (dis)advantages in SA currently are and what SA's portfolio of L advantages implies about how much and what types of FDI SA is currently capable of attracting and in which industries. However, for the reasons outlined in section 2, researchers have increasingly been gathering data on, and trying to understand, the factors behind FDI. As far as we are aware, three publications have resulted from this research: Businessmap's (1997) 'South African Investment Report' which summarizes the results of its research into the FDI commitment under the new government; an IDC paper (IS2/96), which is primarily a summary of the results BusinessMap's research had produced by the end of 1996; and a paper by Mbekeani (1997). According to the BusinessMap data, 72% of the FDI attracted into SA between April 1994 and June 1997, was concentrated in five sectors: Telecommunications (22.2%); Energy and Oil (15.6%); Motor and Components (14.4%); Food and Beverages (13%); and Hotel, leisure and gaming (6.8%). The top 10 foreign companies that invested during this period, their country of origin, and value of their planned investments, are listed below:

<u>Top Ten Foreign Companies</u>	<u>Country</u>	<u>Amount (Rm)</u>
SBC Communication	USA	3,320
Telekom Malaysia	Malaysia	2,200
Coca Cola	USA	2,070
Petronas	Malaysia	1,900
Caltex	USA	1,200
BMW	Germany	1,100
Nestle	Switzerland	600
Goodyear	USA	568
British Petroleum	UK	500
Shell	UK	850

Source: BusinessMap, 1997:9.

Note: The measure of FDI is again restricted to money capital.

Although this conclusion must be seen as tentative until more research has been conducted on the determinants behind and level of exports associated with this pattern of FDI, it suggests that **markets** and **resources** have been the **primary L determinants** and that foreign investors **do not as yet find SA very profitable for export oriented manufacturing FDI**. This is supported by Mbekeani's (1997) research. In an attempt to identify the determinants behind inward FDI in SA, Malaysia and Mexico, Mbekeani applies cointegration and error correction models on a forecasting system using data for the years 1970-1995. According to his results, 'the size of the economy, its growth rates, and



manufacturing profitability are the most important determinants of inward FDI' (Mbekeani, 1997:i). However, for SA, **manufacturing profitability** emerges as a **relatively unimportant determinant** and in addition to the **demand** variables, **political factors** - instability and sanctions - appear **particularly significant**. Interestingly, the fit of the cointegrating vector suggests that the fiscal deficit has no effect in influencing FDI. (Mbekeani, 1997:13). The relative importance of market and resource seeking FDI (particularly in services), and perception that SA does not offer the L advantages necessary for export oriented **manufacturing** FDI, emerges as a cause for concern when viewed against efficiency seeking FDI's role in SAs development strategy<sup>25</sup>. It highlights the need for research to shed light on L disadvantages causing investors to see profitability as poor and the returns to FDI as uncertain in manufacturing industries. The second interesting thing that emerges is that the **relative** importance of FDI types and L determinants at the global level, has been **changing**.

A reading of studies trying to identify the most important L advantages in developing countries between 1950 and 1970, leads to the conclusion that demand variables were most important and that tax incentives and production costs were relatively unimportant. See Caves (1996) for the evidence, here we present two examples of results producing this conclusion. In summarizing the survey results available by the early 1970s, Dunning (1973: 295) concludes that they stress market growth prospects as a determinant and that only a minority of firms appear to have been enticed abroad by lower production costs. In their discriminant analysis of inward manufacturing FDI in 70 developing countries using data for the period 1966-1970, Root and Ahmed (1979) discovered only six essential discriminants. Their results supported the following hypotheses: i. the higher per capita GDP the more attractive the country; ii. comparatively high corporate tax levels deter FDI; iii. the higher the import/export ratio, the greater inward FDI; iv. more urbanized countries attract more FDI; v. the greater the volume of its commerce, transport and communication, the greater inward FDI; and vi. frequent government changes deter FDI. Regarding the role of incentives, they conclude: 'Tax incentives fail to differentiate between the countries...Of the six policy variables...only corporate taxation was a significant discriminator...Attitudes toward joint ventures, local content requirements, and limitations on foreign personnel failed to distinguish these groups'. (Root and Ahmed, 1979:86). By the 1970s a common theme had begun to emerge from the empirical literature: that the primary attraction of developing countries is a large domestic market typically protected by trade policies and that FDI in developing countries could largely be explained by protection-hopping

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<sup>25</sup> The dominance of market seeking FDI and relatively insignificant role of efficiency seeking FDI in SA, is of course, not surprising in light of the privatization of Telkom and legacy of the apartheid government's inward oriented development strategy.

investment and scale economies. This story stuck, even though *a priori* it is doubtful that access to a large domestic market is important to investors wanting to produce for export. (Lucas 1993:391).

More recent empirical work challenges this story. It suggests that whilst production costs, relatively open trade policies and the other L advantages associated with efficiency seeking FDI, were unimportant in the days of traditional import substitution policies, since the 1980s these L determinants and those pulling asset seeking FDI, have taken on more significance. (Again, see the references cited above and particularly Dunning, 1995 and 1998, Lucas, 1993<sup>26</sup> and United Nations 1993). Dunning (1995 and 1998) has been vociferous in arguing: i. that since the 1980s, asset seeking FDI has become increasingly important (particularly in developed countries<sup>27</sup>), whilst efficiency seeking FDI has been increasing relative to the other types of FDI in developing countries; and that ii. this implies that innovative ability, technological competencies and inter-firm linkages with firms showing special R&D capacity, have become more important L factors in developed countries and inter-firm linkages (eg with suppliers), clusters and IDZs<sup>28</sup> together with the other L advantages associated with efficiency seeking FDI, have become crucial in developing countries<sup>29</sup>.

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<sup>26</sup> In testing his model of FDI using data on inward FDI in East and South East Asia for 1960-1987, Lucas found that whilst inward FDI had not been elastic with respect to the cost of capital (including taxes) it had been to wages, and that it was more elastic with respect to aggregate demand in export markets than domestic demand. He attributes this to the dominance of export oriented FDI in the region.

<sup>27</sup> Thus far, most developing countries have largely been excluded from hosting asset seeking FDI. However, one suspects there has been a lot of strategic asset seeking FDI by Korean, Taiwanese, Malaysian, Thai and Brazilian firms in the advanced countries in the 1990s. (Dunning, 1998:54).

<sup>28</sup> 'Agglomeration economies, first identified by Alfred Marshall (1920), enable the participating firms to draw upon a common infrastructure, a specialized pool of labour or customers, develop mutually beneficial relations with their suppliers, and learn from local producer associations and their competitors. Hence, the development of export processing or free trade zones, and the **deliberate** attempts by governments to facilitate industrial districts. Examples of such economic activity in developing countries abound. They are particularly numerous in those countries now attracting the bulk of new FDI in East Asia, viz. China, South Korea, Malaysia Indonesia and Singapore' (Dunning, 1998:54).

<sup>29</sup> These emerging trends in FDI types and L advantages, can be explained by: i. the information technology and communications (ITC) revolution; ii. the economic and political policies ushered in by the neo-liberal counterrevolution; and iii. increasing importance of innovation and inter-firm networks as sources of competition as the lean production system has been changing the organization of global competition. (Freeman and Perez, 1998; Dunning 1995 and 1998; Lipsey, 1997). In an increasingly globalised world in which technology and innovation have become crucial for competitive advantage, ITCs are generic and most new technologies are complex and expensive, firms are increasingly having to focus on core technologies and competencies and tap into other firms' technology and learning experiences. This explains the increase in asset seeking FDI and assists in explaining why investors are looking for clusters and IDZs. The increase in efficiency seeking FDI has been driven by the need for MNCs to rationalize manufacturing operations to compete successfully in a globalized world and the impact of the neo-liberalism on policy formulation in developing countries.

According to Dunning, (1998:53), aside from clusters, efficiency seeking investors are looking for the following in developing countries: cost-effective semi-skilled or skilled labour, good physical infrastructure, minimal distance related costs **and** government policies which are market friendly. Note the absence of tax incentives. There is still a consensus that whilst tax incentives are more important for efficiency than market and resource seeking FDI, and that developing countries without strong L advantages need to match average incentives, tax incentives cannot compensate for lack of other L advantages.

Table Ai and Aii in the appendix, present the OLI determinants identified by the empirical work on FDI determinants under hierarchical capitalism<sup>30</sup> (circa 1948-1979) and Dunning's (1981a, 1995 and 1998) suggestions about how this needs to be modified due to liberalization, globalization and the onset of alliance capitalism. These developments have led some to conclude that: 'Today, in an increasingly globalised world, in so far as demand-related variables are of any influence at all, they are likely to be contained in the ease of access from the micro-region to the macro-region surrounding it' (Dunning, 1997a:13)<sup>31</sup>. One needs to be more cautious when drawing out the implications of these **global** trends in FDI types and L determinants for a **particular** country's FDI and industrial policies. Due to different policies, geographical location, historical ties and factor endowments (including created assets), not all countries have been affected to the same extent by these changes. As we saw above, SA's FDI pattern has not yet begun to reflect that emerging at the global level. These trends do not therefore, undermine the argument that the theory and empirical evidence on FDI determinants calls for country specific industry level studies to identify current L capabilities and how they can be upgraded, **prior** to the design of FDI and industrial policies.

Third, the empirical work on the relationship between political factors and inward FDI in developing countries rests on vague definitions of political variables and is inconclusive. Koechlin (1992) tested three models of outward FDI from the US (1966-1985). Two contained only economic criteria (the 'cost' and 'demand' models); the other included social and political variables (measures of the host country's political stability, overall attitude

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<sup>30</sup> Note, by looking at the L factors under hierarchical capitalism and finding tax incentives and production costs (which were not as important as demand and tariffs in the period 1948-1979) that this table does not rank the OLI determinants according to their significance. It merely lists all those that empirical studies found to have some affect on FDI. The aim of the table is to flesh out the theory developed in section 3 by providing examples of O, I and L advantages and to present the O, I and particularly L determinants, which are according to Dunning, becoming increasingly significant.

<sup>31</sup> For example, 'the Shenzhen special economic zone in Southern China...and the Tumen delta project of North China, are linked much more closely with countries outside China - both for many of their inputs and their markets - than with the rest of China' (Dunning, 1997a:13).

toward FDI, dependence and political ties with the US, and dominant language). The hybrid model proved best at explaining the distribution of outward FDI (Meyer and QU, 1995:7-8). Schneider and Frey (1985) also found that a model with **both** political and economic information explains the distribution of FDI most adequately. Nankani (1979) found aggregate FDI in manufacturing to show at least a weak positive relationship to political stability and negative relationships to hostile investment climate and ideological orientation toward socialism<sup>32</sup>. However, Reuber et.al (1973) found political instability to be relatively **un**important in the distribution of FDI across developing countries. Their evidence also suggested that political instability poses less uncertainty for export-oriented FDI. (Agarwal, 1980:760; Caves, 1996:216). Furthermore, in an analysis of the ASEAN countries, Situmeang (1978) concluded that political instability was statistically unrelated to the flow of FDI in all sectors. The empirical work suggests that whilst political factors matter and together with infrastructure, productivity, skills and innovatory capacity may be a generic L determinant, little is known about exactly how much political instability deters inward FDI, or how the political orientation of governments affects investor sentiment. (Agarwal, 1980:760). All that we can conclude from it is that even if law and order are good for FDI prospects, they are insufficient and for countries with a strong portfolio of L assets, the political factor is less significant than for those with weak set L advantages.

Fourth, the literature is largely silent on how macroeconomic policy and variables affect FDI. One interesting result (aside from Mbekeani's), but one that did not distinguish direct from portfolio investment, is Rodrik's (1996) finding that at present donor behaviour appears to be used by private agents as a perverse signal: `IMF agreements actually appear to reduce private capital flows. (cited in Collier et al, 1997). Does austere fiscal policy undermine inward FDI by stifling aggregate demand and signalling to investors that growth prospects are poor? For developing countries that attract mostly market seeking FDI, this is probably the case. The theory of FDI, we have seen, does not deal with how expectations are formed. It says nothing about how direct investors' expectations are affected by the level of commitment by developing country governments to austere macroeconomic policy or how the size of the budget deficit, inflation and GDP growth rates interact with each other and other L factors to create investor confidence. Until work sheds light on how macroeconomic policy and these macroeconomic variables affect **investor sentiment** across the different types of FDI, all that is clear is that: i. austere fiscal policy reduces FDI in countries that do not have the L advantages needed to attract efficiency and

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<sup>32</sup> If the latter is the case, then how does one explain the recent surge of FDI into China? See Table IV and the argument below on how non liberal industrial policy and authoritarian or socialist regimes do not seem to scare away direct investors.

asset seeking FDI; ii. because of the importance of infrastructure, technology and skills for all types of FDI, a certain amount of government expenditure to upgrade these L advantages is crucial for a developing country to 'crowd in' FDI<sup>33</sup>.

The final point is that the theory and evidence questions the conventional wisdom that a minimalist allocative role for the state in co-ordinating investment and generic supply side industrial policies are **necessary** and **sufficient** to attract FDI.

There is no convincing theoretical model of expectations explaining why MNCs will choose not to exploit a country's L advantages just because that country's government is using demand and supply side incentives to build new L advantages by steering investment into industries identified as crucial for dynamic competitive advantage. Moreover, the recent geography of FDI in the developing world - see Table IV below - contradicts the story that an active and selective industrial policy undermines FDI because investors are frightened of exploiting L advantages in countries where developmental states are trying to push and shape the process of technological learning. The outstanding performers in attracting FDI across both periods - Singapore, China and Malaysia - are countries which, together with Taiwan and South Korea, have convincingly been used by revisionists to show how selective industrial and technology policies and strategic management of foreign resource inflows by efficient developmental states, can lead to remarkable industrial export diversification, growth and development<sup>34</sup>.

**Table IV: Largest developing country recipients of inward FDI 1975-1980 and 1990-94 (annual averages, \$m)**

Country	1975-80 % of all Developing Country FDI	Country	1990-94 % of all Developing Country FDI

<sup>33</sup> As Serven (1992:286) concludes in his comments on the lessons that can be drawn from the evidence on the type of policies required for a recovery of FDI in developing countries: 'the first lesson is that public investment seems to matter - and to matter greatly'.

<sup>34</sup> For the evidence on how Singapore's government used industrial policy to build new competitive advantages and managed to attract large quantities of FDI to use in this process, see Lall (various) and Lim (1995). The most recent edition of Dornbusch and Fischer's (1997:71-72) *Macroeconomics* notes how Alwyn Young has drawn attention to the role of Singapore's government in controlling the allocation of resources and trying to push the rate of growth in the economy and its ability to attract large quantities of FDI for the technological upgrading process. For an overview of how developmental states used industrial policy in East Asia to raise domestic investment and build new competitive advantages (create the 'East Asian Miracle' of rapid industrial development), see Amsden (1994) and Lall (various). For Malaysia, see Zainuddin (1993). On China, see White (1996).

Brazil	1835.8		24.4	China	16064.8		27.9
Mexico	1023.5		13.5	Singapore	6384.4		11.1
Malaysia	524.3		7.0	Mexico	4332.0		7.5
Singapore	502.0		6.7	Malaysia	4243.8		7.4
Egypt	371.6		5.0	Argentina	3191.8	5.5	
Iran	315.5		4.2	Thailand	2197.8		3.8
Indonesia	289.9	3.8		Indonesia	1871.2	3.2	
Hong Kong	241.1		3.2	Hong Kong	1596.8		2.8
Top 8	5108.2		67.8	Top 8	39882.6		69.2
All	7539		100.0	All	57623.8		100

Source: Dunning, 1998:50.

The fact that the evidence seems to contradict the story that the job of attracting large quantities of FDI in developing countries can be largely left to markets is not surprising. Developing countries desperate to attract FDI by definition have a shortage of skills and innovatory capacity (both at the level of the firm and state), weak manufacturing capabilities, small markets, slow growth, and poor infrastructure. The theory and evidence on what motivates MNCs to engage in international production, implies that unless a developing country:

- i. is 'blessed' with labour costs and legislation seen by efficiency seeking investors as sufficiently poor to 'compensate' for these L disadvantages;
- ii. has natural resources to attract resource seeking FDI; and/or
- iii. has tariffs/quotas and transport costs that are sufficiently high to generate market seeking FDI

it will not find it easy to attract the skills, learning experiences, technologies and finance embodied in MNCs. By assuming a deterministic link between liberalization and inward FDI (when no such link exists), inflating the FDI response to incentives, down playing the role of L advantages such as demand, skills, infrastructure and innovatory capacity and not seeing that these have to be created within potential host countries, the neo-liberal understanding of FDI determinants (implicit in SA's new industrial strategy) and story about what kind of policies can kick start development, may thus be placing the cart before the horse<sup>35</sup>. In the words of Dornbusch (1992:275) 'the importance of opportunities, prosperity and complementary investments in creating a setting in which FDI will flourish, implies that we should be far more cautious in advancing the view that the right policies can make any

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<sup>35</sup> This conclusion, that the theory and empirical evidence suggests that FDI seems to follow growth, is supported by the literature on the 'investment development cycle'. See Narula and Dunning (1996).

place a place in the sun'. Instead of explaining why a developing country government can rely on inward FDI provided it reduces the size of its budget deficit and management of markets, our analysis suggests that better FDI prospects in many developing countries may **wait upon innovation by governments which results in the implementation of policies that mobilize domestic investment resources to ensure that better L advantages are created and growth performance is generated.**

### **Conclusion - The inferences for development prospects, policy and research in SA**

So, how persuasive is the understanding of FDI determinants in SA's new FDI and industrial development strategy? How much FDI should we expect it to generate? What kind of research is needed to improve FDI policies and prospects in SA?

As we have seen, SA has traditionally attracted mainly market and resource seeking FDI. Moreover, in spite of government's recent commitment to fiscal austerity and liberalization, and its marketing of the SDI and IDZ, SA's current L advantages have not as yet attracted much efficiency seeking manufacturing FDI. Our analysis tells us that this is not surprising. The understanding of FDI determinants behind SA's development strategy: i. focuses too much on ensuring that the 'wrong' policies do not deter FDI and too little on institutional, infrastructural, factor and market related L determinants of FDI; ii. is built upon a questionable vision of how fiscal austerity, liberalization and supply side incentives will generate inward FDI; iii. pays too little attention to detailing the types of L advantages and industries we can realistically expect to attract FDI in the short-run; and iv. fails to see that the ability to attract large quantities of new FDI **may** depend upon a more expansionary fiscal and active industrial policy stance than that envisaged.

It follows that we should not expect current policies to generate the quantity and type of FDI seen in GEAR and the new industrial strategy as necessary for FDI to assist in launching the economy onto a higher growth path.

What does our analysis imply about research needs?

**!** We need to think about how we can access more holistic and useful data on MNCs activity in SA. Improving our understanding of FDI determinants and policy design will depend upon improvements in the methodology used to monitor inward and outward FDI. More specifically, we need more disaggregated data on money capital

inflows and information on the extent and nature of technology, management and non money capital flows into different firms and industries.

- ! We need to use historical studies to: i. gain more detailed knowledge on the form of state action in those developing countries that have been successful in attracting the type of FDI that SA is courting and in using it to enhance competitiveness; ii. assess the extent to which these countries' ability to attract and benefit from inward FDI was linked to these policies; and iii. uncover the lessons that can be learnt for SA on the form of institution building and policy action required to enhance SA's attractiveness as an export platform.
  
- ! More empirical studies aimed at identifying the past pattern of FDI into SA, the L determinants behind it and the exports and imports associated with it, are needed. In addition to econometric work which uses aggregate official data on inflows of money capital, we need industry specific studies of SA's L (dis)advantages. Even if the policy regime was very different in the 1980s from what it is today, and SA's L advantages were not exploited during the later years of the apartheid era, this type of information would still be useful. It would facilitate more rigorous predictions about the type and quantities of FDI that we can realistically expect to attract and provide information that would facilitate more selective and efficient investment by government in its attempt to create the L advantages needed to attract the form of FDI that it sees as important for its development agenda.
  
- ! But what is perhaps needed most, is survey results, based on information gathered from decision makers within MNCs that have either recently invested in SA, are deciding whether to invest, or have decided not to invest. These are required to: i. supply us with information on the relative role of factor costs, input costs, institutional, social and political variables in undermining the profitability of efficiency seeking FDI in manufacturing industries in SA; and ii. provide us with more information on the significance of macroeconomic variables such as the size of the budget deficit and inflation in influencing expected investment returns and about whether continued commitment to neo-liberal policies is seen as necessary by potential investors for SA to be an attractive investment location. Gathering responses to the last question is particularly important. For, even though the theory and evidence on FDI determinants tells us that we should not expect this to be the case, if the foreign direct investors we are trying to entice into SA do currently believe this story, then until their perceptions are altered there will be little that government and domestic private sector actors can do to ensure that MNCs will



combine more of their O advantages with SA's L specific advantages.

## APPENDIX A

**Table Ai: O Advantages under Hierarchical Capitalism and additional O Advantages that have become significant under Alliance Capitalism**

Hierarchical-Related Advantages	Alliance-Related Advantages
<p>a. Property right and/or intangible asset advantages (Oa)</p> <p>Product innovations, production management, organizational and marketing systems, innovatory capacity, learning experiences and tacit knowledge.</p> <p>b. Advantages of common governance, i.e. of organizing Oa with complementary assets (Ot)</p> <p>i. Those that branch plants of established enterprises enjoy over <i>de novo</i> firms</p> <ul style="list-style-type: none"> <li>- those due to size, product diversity and learning experiences of enterprise, e.g., economies of scope and specialization.</li> <li>- favoured access to inputs - e.g., labour, natural resources, finance, information - and to markets</li> <li>- ability of parent company to conclude productive and cooperative inter-firm relationships</li> <li>- access to resources of parent at marginal cost.</li> <li>- synergistic economies (in production, purchasing, marketing and finance arrangements).</li> </ul> <p>ii. Which specifically arise because of multinationality. (Multinationality enhances operational flexibility by offering wider opportunities for arbitraging, production shifting and global sourcing of inputs).</p> <ul style="list-style-type: none"> <li>- more favoured access to and/or better knowledge about international markets.</li> <li>- ability to take advantage of geographic differences in factor endowments, government intervention and markets.</li> <li>- ability to diversify or reduce risks, e.g., in different currency areas, and creation of options and/or political and cultural scenarios.</li> <li>- ability to learn from societal differences in organizational and managerial processes and systems.</li> <li>- balancing economies of integration with ability to respond to differences in country-specific needs and advantages.</li> </ul>	<p>a. Vertical Alliances</p> <ul style="list-style-type: none"> <li>- backward access to R&amp;D, design engineering and training facilities of suppliers and regular input by suppliers on problem solving and innovation</li> <li>- forward access to industrial customers, new markets, marketing techniques and distribution channels, particularly in unfamiliar locations where products need to be adapted to meet local supply capabilities and markets.</li> </ul> <p>b. Horizontal Alliances</p> <ul style="list-style-type: none"> <li>- access to complementary technologies and innovatory capacity.</li> <li>- access to capabilities to capture benefits of technology fusion, and to identify new uses for related technologies.</li> </ul> <p>c. Networks</p> <p>i. of similar firms</p> <ul style="list-style-type: none"> <li>- reduced transaction and coordination costs arising from better dissemination and interpretation of knowledge and information, and from cooperation between members of network.</li> <li>- improved knowledge about process and product development and markets.</li> <li>- multiple, complementary, inputs into innovatory developments and exploitation of new markets.</li> <li>- access to embedded knowledge of members of networks.</li> <li>- opportunities to develop 'niche' R&amp;D strategies; shared learning and training experiences, e.g., as in the case of cooperative research associations.</li> </ul> <p>ii. business districts</p> <ul style="list-style-type: none"> <li>- as per i plus spatial agglomerative economies, e.g., labour market pooling.</li> <li>- access to clusters of specialized intermediate inputs, and linkages with knowledge-based institutions, e.g., universities, technological spillovers.</li> </ul>

**Table Aii: I and L Advantages under Hierarchical Capitalism and additional I and L Advantages that have become significant under Alliance Capitalism**

<p><b>Hierarchical-Related I Advantages</b></p> <p>Avoidance of search and negotiating costs, moral hazard and information asymmetries.</p> <p>Avoidance of costs associated with buyer uncertainty (about nature of and value of inputs - e.g. technology - being sold)</p> <p>Need of seller to protect quality of intermediate and/or final products</p> <p>When market does not permit price discrimination.</p> <p>To avoid or exploit government intervention (e.g., quotas, tariffs, tax differences)</p> <p>To control supplies and conditions of sale of inputs (including technology).</p> <p>To control market outlets.</p> <p>To be able to engage in practices, e.g., cross-subsidization and transfer pricing as a competitive strategy.</p> <p>To capture economies of interdependent activities - ie economies associated with governance of interrelated value-added activities - (see b. above) and those associated with learning experiences</p>	<p><b>Alliance-Related I Advantages</b></p> <p>Greater role for internalization advantages arising from the ownership and/or control of inter-related activities in different geographical areas. These include spreading of political and environmental risks, and the holistic integration of disparate functions and strategies.</p> <p>While, in some cases, time limited inter-firm cooperative relationships may be a substitute for FDI; in others, they may add to the I incentive advantages of the participating hierarchies, R&amp;D alliances and networking which may help strengthen the overall competitiveness of the participating firms. Moreover, the growing structural integration of the world economy is requiring firms to go outside their immediate boundaries to capture the complex realities of know-how trading and knowledge exchange in innovation, particularly where intangible assets are tacit and need to speedily adapt competitive enhancing strategies to structural change.</p>
<p><b>Hierarchical-Related L Advantages</b></p> <p>Traditional L variables relating to</p> <ol style="list-style-type: none"> <li>i. domestic factor costs</li> <li>ii. market size and growth</li> <li>iii. transport costs and other economic and psychic barriers</li> </ol> <p>Government imposed incentives and disincentives to FDI including performance requirements.</p> <p>Artificial barriers (including import controls) to trade in goods</p> <p>Infrastructure provisions (transport, communications, commercial, legal, educational)</p> <p>Economies of centralization of R&amp;D production and marketing</p> <p>A stable political and economic regime</p> <p>A market facilitating macro-economic environment</p>	<p><b>Alliance-Related L Advantages</b></p> <p>The provision of location-bound resources and capabilities which help firms both to exploit and upgrade their existing competitive advantages</p> <p>The continual upgrading of location bound assets so as to promote increasingly high-value FDI</p> <p>The L advantages of alliances which arise essentially from the presence of a portfolio of immobile local complementary assets and which when organized within a framework of alliances and networks, produce a stimulating and productive industrial atmosphere (the extent of business districts, industrial or science parks and the external economies they offer are eggs of these advantages which over time may enable MNCs to better tap into, and exploit, the comparative advantages of host countries).</p>

Source: Compiled from Dunning, 1981a:80-81, 1995:475-476 and 1998:56.

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