edtea

Department :
Economic Development, Tourism and Environmental Affairs
PROVINCE OF KWAZULU-NATAL

Investment Promotion and Facilitation Strategies for the District Municipalities [Harry Gwala, Umkhanyakude, Zululand]

Situational Analysis Report

Part 1

(Policy Review & FDI trends)

Draft

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PART 1 - LIST OF ABBREVIATIONS

AGOA	African Growth and Opportunity Act
BITs	Bilateral Investment Treaties
BR&E	Business Retention & Expansion
BRIC/BRICS	Brazil, Russia, India and China/BRIC + South Africa
DA	District Agencies
DM	District Municipality
DEDT	Department of Economic Development and Tourism (now EDTEA)
DMIPSF	District Municipality Investment Promotion and Facilitation Strategy
(**The**) **dti**	The Department of Trade and Industry
EDTEA	KZN Department of Economic Development, Tourism and Environmental Affairs
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDFI	Gross Domestic Fixed Investment
GDP	Gross Domestic Product
GEM	Global Entrepreneurship Monitor
GFCF	Gross Fixed Capital Formation
GIPB	Global Investment Promotion Best Practices
GVA	Gross Value Added/Addition
IDC	Industrial Development Corporation
IPA	Investment Promotion Agency
IPAP	Industrial Policy Action Plan
IDZ	Industrial Development Zones
IPAs	Investment Promotion Agencies
IPF	Investment Promotion and Facilitation Forum
IPFS	Investment Promotion and Facilitation Strategy
KZN	(The Province of) KwaZulu-Natal
KZN-PGDS	The Provincial Growth and Development Strategy for KwaZulu Natal
LED	Local Economic Development
M&As	Mergers and Acquisitions

MCEP	Manufacturing Competitiveness Enhancement Programme
MNEs	Multinational Enterprises
NDP	National Development Plan
NER	(The) National Electricity Regulator
NGP	New Growth Path
OECD	Organisation for Economic Co-operation & Development
PGDP	Provincial Growth and Development Plan
PGDS	Provincial Growth and Development Strategy
R&D	Research and Development
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SEDA	Small Enterprise Development Agency
SEZs	Special Economic Zones
SMEs	Small and Medium Entreprises
SOEs	State Owned Entreprises
TIKZN	Trade & Investment KwaZulu-Natal
TKZN	Tourism KwaZulu-Natal
TISA	Trade and Investment South Africa
ToRs	Terms of Reference
UDMA	Umhlosinga Development Agency
UNCTAD	United Nations Conference on Trade and Development

1 INTRODUCTION

The KZN Department of Economic Development, Tourism and Environmental Affairs (EDTEA) with the Zululand District Municipality developed the Investment Promotion and Facilitation Strategy for Zululand.

The Terms of Reference (ToRs) specify that the situational analysis, which is a *status quo* analysis exercise with results presented in a report, needs to incorporate a "consolidation of existing information, reports and strategies such as EDTEA's District Comparative Advantages Report; Quantec data; Provincial Growth and Development Strategy, Provincial Investment Strategy; draft Provincial Export Strategy; Special Economic Zones and Industrial Hubs Feasibility Reports, amongst others." The ToRs then specify that "this exercise should:

- Ascertain present investment climate within the district taking into account both its external and internal environment."

This part (Part 1) of the situational analysis report focuses on the investment climate that prevails in the international, national and provincial arenas so as to contextualize the future development of the District Municipality Investment Promotion and Facilitation Strategies. Part 2 of the situational analysis, which accompanies this part of the report, details the situation in the District Municipalities; as such, part 2, which reports on an analysis of the internal investment environment needs to be looked at in conjunction with part 1.

In turn, the ToRs require, amongst others:

- "Research on current investment incentives, initiatives and policies as well as [an] investigat[ion] of future plans and strategies for the district."

Given that most incentives, initiatives and policies affecting investment, generally as well as sectorally, are specified at the national and at the provincial levels, such measures and policies are set out in this part of the situational analysis. Incentives, initiatives and measures that are found to be district-specific are detailed in Part 2 of the situational analysis report since this part of the situational analysis is focused on district specifics.

To summarise, and to clarify the overall structure of the situational analysis report and the split of the main report into two main parts, Part 1 of the situational analysis has been structured so as to specifically report on elements of the international, national and provincial arenas "to devise individual District Municipality Investment and Promotion and facilitation Strategies" for Harry Gwala, Umkhanyakude and Zululand. Part 2 zooms onto the specifics of the aforementioned District Municipalities (henceforth DMs).

2 CONTEXT OF THE SITUATIONAL REPORT

The project which involves the drafting of Investment Promotion and Facilitation Strategies for three DMs is conducted for the Trade and Investment Promotion sub-programme that is within the Trade and Industry Development Programme of the EDTEA. The Trade and Industry Development Programme seeks to "transform the provincial economy, to ensure job creation and long term sustainable growth."

As specified in the ToRs, efforts to improve investments within the province need to be heightened so as to address the problem of unemployment through job creation. The challenge is enormous with the New Growth Path setting the target of creating 5 million jobs by 2021 while the national context is currently one of slow growth.

A Provincial Investment Strategy has been developed to "operationalize investment efforts". This Strategy, endorsed in June 2011 by Cabinet, recommends that District Municipality Investment Promotion and Facilitation Strategies (henceforth DMIPFS) be devised for each District Municipality. The DMIPFS have to be tailored to what is happening directly in the districts although the broader provincial and national context influences this and the set of available opportunities for expansion. The DMIPFS has to "help identify and promote priority sectors within the diverse district economies" while ensuring that they are devised in such a way so as to help counter the current "weaknesses of each district".

This report is Part 1 of the second deliverable of the project as described above.

3 STRUCTURE OF PART 1 OF THE SITUATIONAL ANALYSIS

This part of the situational analysis report is structured in 4 main large sections. After a brief presentation of the methodology followed in part 1 of the Situational Analysis (Section 4) and a some key concepts pertaining to investment that are used extensively in the report (Section 5):

- Section 6 zooms onto a presentation of the determinants of investment. This section sets a background for particular elements that shape the content of a DMIPFS as well as its limits;
- Section 7 briefly describes some key aspects of investment promotion and facilitation and some strategies followed and agencies set up to help attract

investment;

- Section 8 presents the policy environment in South Africa and in KZN and relay information on key policies and actions that are relevant from a domestic and foreign investment perspective. This section also briefly presents the relations South Africa has with other countries. This section is a central part of the Situational Analysis because it provides key details on how fixed investment expansion is to be unlocked in South Africa from the perspective of policy-makers.

- Section 9 describes the key patterns and trends of investment in South Africa, KZN and the DMs looked at for the project.

The large sections are each structured in such a way that they each end with a summary sub-section that draws key points that help inform a DMIPFS.

4 METHODOLOGY FOR THE ANALYSIS OF THE INFORMATION PRESENTED IN PART 1 OF THE SITUATIONAL ANALYSIS

The information presented in Part 1 of the situational analysis refers to key material looked at through a desktop analysis approach. This approach was selected as it suited the objective of this particular part of the Situational Analysis.

The key documents consulted were chosen taking into their quality (reliability and acceptability). Separately, some raw data have also been processed for this report. We detail next some of the key material consulted and present some data limitations.

4.1 Key Sources of Information used in this report

4.1.1 Documents

Some of the important documents consulted for Part 1 of the Situational Analysis include reports produced by international organizations:

- Since the World Bank and the United Nations Conference on Trade and Development (UNCTAD) work on investment, on competitiveness and provide particular indicators for South Africa and other countries on a range of topics, documents from these sources were looked at.

Documents from other international agencies that also engage with on high level economic issues (such as the Organisation for Economic Co-operation & Development/OECD) have also been looked.

Key policy and reference documents have been processed for South Africa and the Province of KwaZulu-Natal. These documents include all those specified in the ToRs although additional policy documents were also looked at whenever these were found to be relevant for the project.

4.1.2 Data

Data have been extracted from a variety of key sources but UNCTAD is, internationally, the main agency of reference for foreign direct investment (FDI) data; UNCTAD corrects and make available these data, publicly, for all countries for a number of years. The analysis of international FDI data on an annual basis is reported in an annual UNCTAD publication called the *World Investment Report* although the central focus of the Report in the presentation of the data tends to vary from year to year. The main source for such data in South Africa is the South African Reserve Bank (SARB). These are reported directly in the *Quarterly Bulletin* publications for short periods of time.

Information on *Doing Business* is available from the World Bank. Data collected by the Bank and that are presented in the *Cost of Doing Business* reports are important to help position South Africa on a number of, albeit only a subset, determinants of investment internationally. Such positioning is possible because the Bank engages in similar surveys in a number of countries the world over.[1]

Of note with regards to the *Cost of Doing Business* is that the World Bank has been, since 2005, evaluating the Cost of Doing Business for large cities (covered in sub-national reports). Nine cities and four ports have been surveyed in South Africa since 2005. ***No*** survey has been undertaken for the smaller cities and for District Municipalities to date. As such, we only mention that large differences have been identified in the cost of doing business across cities within countries. Although some relevant indicators of the *Cost of Doing Business* are presented in this part of the Situational Analysis report for South Africa as a whole, the method currently used by the *Cost of Doing Business* could be assessed, going forward, to conduct a similar exercise in DMs. However, part 2 of the situational analysis reports on information that cuts across the type of information collected and

[1] The OECD, in contrast, specifically looks at the regulatory environment and reports on these for individual countries as well as provides indicators of FDI restrictiveness for some countries on its database.

analysed for the *Cost of Doing Business.*

Finally, some data presented in Part 1 of the Situational Analysis report have been extracted from Quantec, a private data company that collects and processes data for a very large range of economic indicators. Quantec is a key source of data for KZN and for District and Local Municipalities in the province and beyond. Quantec also provides trade data at a geographical level that is more refined than what is available from a number of sources.

4.2 Data Issues

Three main issues are to be noted with regards to the data that are presented for this report.

- Firstly, data from Quantec (similarly to data that can obtained from other private data service providers) are *inputed* rather than actual data. What this means is that economic data for the province and for smaller geographical units of analysis (e.g. for District or Local Municipalities) are data that are *derived*. These data are produced through models and use assumptions on the economic contribution of these smaller spatial units of reference.[2]

- Second, we note that data collected for South Africa by the World Bank as part the Cost of Doing Business evaluations illustrate what is happening on the ground. The data are not representative of the situation confronting businesses.

- As for foreign investment data, these are not publicly available, in and for South Africa at a detailed sub-sectoral level. Data are only available for the main economic sectors, that is for: mining; manufacturing; finance and services; trade and accommodation; and, transport and communication. This is because South Africa is comparatively small (in its production and in its investment base) - the release of data for sub-sectors could render who the larger investors/deals easily identifiable.[3]

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[2] Data obtained from national data collection agencies such as StatsSA with information collected from a subset of respondents in particular areas are considered for this. StatsSA tends to collect data using samples rather than a population given the high cost of collecting information on a large scale. The number of who to approach is defined using rigorous statistical techniques with statistical adjustments made to the data for these to be representative in a number of cases.

[3] More broadly FDI data are not always accurate. This is for a number of reasons but include the fact that firms that invest across borders might operate in a number of countries that have different recording methodologies; moreover, because firms have complex links with each other, which is the exact origin and destination of a cross-border transaction is, at times, hard to establish. Also, what is domestic investment is at times reclassified as foreign

In parallel data are only available for the country as a whole while investment promotion has tended to be largely driven by provinces. This is an important data gap. The only reliable source of data for foreign direct investment at the DM level in KwaZulu-Natal is Trade and Investment KwaZulu-Natal (TIKZN). TIKZN has data for FDI projects – value of committed FDI and number of jobs associated with each of these projects. However, TIKZN only collects the information when it is approached and involved; and, in some cases, foreign direct investment involves another party or no party.

5 KEY INVESTMENT TERMS & CONCEPTS

Two main types of investment are the domain of a DMIPFS, domestic and foreign direct investments. We explain what such investments mean below.

Domestic investment is typically captured through fixed capital formation.

- **Gross fixed capital formation** (formerly gross domestic fixed investment) is total fixed investment by private companies and individuals, state owned enterprises (SOEs) and government. GFCF refers to the net increase in fixed capital (investment minus disposals) in a period.

  The investments looked at include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings.[4]

- **Fixed investment** is an investment that is made in fixed capital, that is investment in physical assets. These are assets that can be sold.

Foreign direct investment (FDI) refers to significant investments made by foreign investors.

investment when a national company redemociliates, that is becomes registered in another country as its main operating country.

[4] Note that, as summarized, on Wikpedia: "GFCF is *not* a measure of *total* investment, because only the value of net additions to fixed assets is measured, and all kinds of *financial* assets are excluded, as well as stocks of inventories and other operating costs (the latter included in intermediate consumption). If, for example, one examines a company balance sheet, it is easy to see that fixed assets are only one component of the total annual capital outlay." (See https://en.wikipedia.org/wiki/Gross_fixed_capital_formation, retrieved 12 December 2015).

- Significance is defined in terms of a “significant influence”, that is a lasting and important management interest or effective control through acquisition or creation of assets in a company.
- The term foreign refers to such assets being created outside of a home economy.[5] The investment happens outside a border through: (i) a new company being set-up (e.g. a subsidiary, which is a branch of the mother company); (ii) the acquisition of a foreign company, or through a merger (when companies are combined) or joint venture (when resources are pooled across parties to create a new company).

Two main concepts are relevant that help understand what is being talked about when discussion FDI[6]: FDI stock and FDI flows.[7]

- **FDI stock** is the value of share of capital and reserves (including retained profits) attributable to a parent enterprise, plus the net indebtedness of affiliates to a parent enterprise.

- **FDI flows**, relate to financial flows; according to the Organisation for Economic Co-operation and Development (OECD) “Financial flows consist of equity transactions, reinvestment of earnings, and intercompany debt transactions.” In other words, flows are capital supplied by a foreign direct investor or capital obtained from an investing company by a foreign direct investor.

- The two above concepts are somewhat linked from the perspective that stocks are the result of previously cumulated flows.[8]

In turn, FDI are of two types, outward or inward. **Inward** FDI are direct investments made in a particular economy. **Outward** FDI are direct investments made outside an economy, e.g. direct investment abroad.

Taking into account the difference between flows and stocks specified above, **FDI outflows** reflect the value of outward direct investment made by residents of a reporting economy to other economies; for the OECD, “Outward flows represent transactions that increase the investment that investors in the reporting economy have in enterprises in a foreign economy, such as through purchases of equity or reinvestment of earnings, less any transactions that decrease the investment that investors in the reporting economy

[5] Negative values when these data are presented indicate disinvestment, that is reverse investments.

[6] Direct investments are distinct from indirect investments (e.g. overseas institutions invest in equities listed on a nation's stock exchange). Portfolio foreign investments are passive investments in stocks and bonds.

[7] Data on FDI stock is typically preferred in analyses of FDI trends when these are available.

[8] However, changes in FDI stock cannot be equated to FDI flows. Exchange rate movements and depreciation rates matter when establishing a link between flows and stocks.

have in enterprises in a foreign economy, such as sales of equity or borrowing by the resident investor from the foreign enterprise."[9] **FDI inflows** are the reverse; using the OECD definition "Inward flows represent transactions that increase the investment that foreign investors have in enterprises resident in the reporting economy less transactions that decrease the investment of foreign investors in resident enterprises."

Inward FDI stock is the value of foreign investors' equity and net loans to enterprises resident in the reporting economy. **Outward FDI stock** is the value of resident investors' equity and net loans to enterprises in foreign economies.

6 DETERMINANTS OF INVESTMENT

We set out in what follows the factors driving the two main types of investments considered in the situational analysis and which are domestic and foreign direct investments.

Stressing from the onset that the discussion which follows is not comprehensive and that particular determinants need to be given emphasis in particular context, we focus, in what follows, on some broad elements that influence investment before turning attention to specific elements which were emphasised as part of the project – e.g. administered prices, entrepreneurship, innovation and access to capital. We then present how particular factors driving investments and which are in the policy domain are evaluated under the heading of *Costs of Doing Business*. We then wrap up the discussion on the theme of investment determinants by setting up their implications for a DMIPFS.

6.1 Overview of determinants

A number of general determinants of 'large' scale investment can be found in the literature though the importance of each of these varies depending on the approach, methodology and country looked at. Broadly speaking, however, the main factor that drives investments is the investment climate, that is:

> The economic and financial conditions in a country that affect whether individuals and businesses are willing to lend money and acquire a stake in the businesses operating there. [10]

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[9] OECD (2015), FDI flows (indicator). doi: 10.1787/99f6e393-en (Accessed on 08 December 2015)

[10] From: Investment Climate Definition | Investopedia http://www.investopedia.com/terms/i/investmentclimate.asp#ixzz3uCkPI5Uc

The above is representative of how an investment climate tends to be defined; broadly, all investment climate definitions have in common references to the overall economic climate and to governance in the form of institutional arrangements, rules and regulations.[11] Nevertheless, a useful variation of the definition is that set out by one of the former chief economists at the World Bank, and which is that the investment climate is the "policy, institutional, and behavioral environment, both present and expected, that influences the returns, and risks, associated with investment [in a specific location]". This definition emphasizes that financial considerations are associated with an investment and the expectation dimensions associated with these.

Expectation dimensions and returns are captured in another concept, that of the economic climate, including in the form of growth. The economic climate is a central component of the investment climate because whilst investment includes the replacement of the machinery and equipment used during production, it is also driven by prospects derived from an expansion of the production capacity in the case of fixed investments.

As such, economic growth is a key driver of investment growth. Growth influences business confidence, interest rate levels and changes, etc., that are underlined by positive changes in aggregate demand. These impact on the returns made from investment. In turn, factors that increase domestic savings (including capital inflows into an economy) are critical because they allow more funds to be available for investment purposes. Noting this, the following are conventional general determinants of (in the sense of proxy for) investment:

- Business confidence with low levels of business confidence indicative of uncertainty about the future causing firms to postpone their investments;
- Changes in national income;[12]
- Interest rates as these represent the cost of borrowing. When interest rates are high, investors would prefer to hold investment money in a fund earning interests rather than invest. New investors who have to repay loans on new investment might be deterred from borrowing when interest rates are high. Not only are producers and potential investors affected by rising borrowing costs, consumers themselves might reduce their spending when this happens.

  Interest rates are considered together with other costs that affect a business (e.g.

[11] Thus, for Investopedia, all the main aspects of an economy shape the investment climate: "Investment climate is affected by many factors, including: poverty, crime, infrastructure, workforce, national security, political instability, regime uncertainty, taxes, rule of law, property rights, government regulations, government transparency and government accountability".

[12] An interesting finding on this is that small changes in income boost investments to high levels as firms tend to unable to buy new machinery and equipment and/or to set up plant for small demand changes. That is, there tends to be strong effects from small income changes on investment levels.

business taxes, particularly when such taxes bear disproportionately on the smaller businesses.)

These can be unpacked further. For the African economies as a specific subset of developing countries,[13] UNCTAD[14] reports the following determinants of investment:

- **poor access to credit and high cost of finance**, particularly for the smaller firms operating in the private sector. However, countries with high lending rates on the continent are those which UNCTAD considers to be at more than 20%. This is not case of South Africa which is significantly below the African average; South Africa thus has an advantage around relative to a number of other countries on the continent with regards to finance.

  Another advantage in terms of South Africa's relative position within Africa is is with regards to that financial intermediation. This is relatively low in Africa but not in South Africa; UNCTAD emphasises that this is *causing* the high interest rate costs[15] observed in some African countries.

  UNCTAD reports on research that has identified that "interest margins are positively associated with market concentration and that bank-specific-factors such as credit and liquidity risks are also important …. [and that] interest rate spreads are affected mostly by macroeconomic policy variables." (p. 31) The latter relates to inflation, exchange rate fluctuations etc. although banking concentration also plays a role in this.

- **low domestic savings**. This is important since private domestic fixed investment needs to be developed on the African Continent.[16]

  While we will show later on in this report that South Africa is affected by low domestic savings, domestic saving levels are particularly important when high

[13] With levels of developments of the DMs under scrutiny in this situational analysis relatively low, the focus on African countries is relevant.

[14] See UNCTAD (2014) *Economic Development in Africa – Catalysing Investment for Transformative Growth*. Geneva: The United Nations.

[15] This is about the interest spreads and margins.

The interest rate spread is the amount by which the interest earned through an investment exceeds/fails to exceed the interest liability. To put it simply: "If a bank pays depositors one interest rate, and lends the deposited money out at a higher interest rate, the difference between those two interest rates is the interest rate spread." The larger the spread the more a bank earns from its lending. Spreads are an indicator of the cost of handling money and of the risks confronting banks when lending in a particular market.

[16] Foreign investment also needs to be markedly developed on the Continent as it is persistently underperforming relative to other world regions.

levels of investment are required to jump start growth. UNCTAD considers that low domestic savings in African countries is related to the predominance of informal activities amongst all *private* economic activities. (This is important considering that information activities are important in the smaller cities in South Africa.)

Evidence reveals that there is, not only a positive relationship between investment and growth but also between savings and growth and between savings and investments.

Low domestic savings tend to shift attention on foreign (direct) investment. Although large number of benefits have been attributed to such investments, these also represent a risk as such investment tendsto be footloose.

- **Risk and uncertainty**. This is a problem for a number of countries on the African Continent that experience not only a volatile macroeconomic climate but also policy reversals which generate uncertainty. Since investment decisions are irreversible, a high level of uncertainty can severely deter investors.

  While macroeconomic volatility is not a feature of South Africa which is considered to have a strong macroeconomic performance, there are cases of policy reversals and uncertainty caused by long delays in the finalisation of particular pieces of legislation. Uncertainty also occurs when there are long delays in the issuing of documents require by the investors to initiate a project, when decisions are not transparent and/or based on complex decision-making (e.g. land zoning or land acquisition for agriculture). Complex decisions disproportionately deter the smaller private investors.

- **Inequality and low level of aggregate demand**. While aggregate demand is critical investment determinant, inequality shapes perception of risk in the economy as well as the pattern of property rights. Inequality is also symptomatic of the presence of imperfections (e.g. in terms of access to credit or collaterals). Inequality has been found to depress investment in South Africa.

- **the policy and investment environment**. The context generally impacts on the ability of firms to be competitive. UNCTAD stresses this around the position of African countries in the Global Competitiveness Index relative to other regions.

Lower risks in the form of political stability, and risks protecting foreign investors matter under this heading.

Although not detailed in UNCTAD but by the World Bank in various reports, the following is identified as critical elements of the investment environment:

- The state of infrastructure and new infrastructure and projects that have a developmental impact; in fact the state of infrastructure has been found to be more important than the presence of incentives for larger investors (particularly for the foreign investors)

- The state of the labour force and change of this through education and skills development although these also impact on investment indirectly through their developmental impacts. Skills development is important when it releases the human resource development constraints that confront an investor.

  The above form the basis of "an adequate physical and social infrastructure that complements a good policy and regulatory framework to create the necessary environment for attracting and retaining investment."

The factors listed above are important for foreign as well as for domestic investors. However, FDI is influenced by significantly more complex factors; decision-making in the case of FDI relates to an analysis of the specific advantages which a foreign company obtains in setting up in a particular market when compared to engaging in other forms of transaction (e.g. import).

There are many theories of FDI but a particular well-known approach refers to foreign firms that invest directly abroad not only having particular structures that yield ownership and internalisation of cost advantages but also to having location advantages. Strong location advantages push the firm to locate abroad according to this theory. Localisation determinants then define where to locate.

Many types of firms are considered in FDI theories but two types of firms, resource- or market-seeking,[17] are worth noting because while one emphasises factors of production, the other one emphasises consumption/supplying conditions and positional strengths around these:

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[17] A third traditional category is that of an efficiency seeking foreign firm. This is associated with firms taking advantage of differences in costs and of specific difference in consumer tastes and/or supplier capabilities.

- Resource-seeking is defined by advantages associated with either acquiring new resources (e.g. raw materials) or tapping onto resources abroad that are strategic assets or at lower costs than in the home economy (e.g. a workforce);
- Market seeking is related to securing larger markets in the form of either consumers or suppliers. Markets are moreover looked at outside domestic boundaries: foreign firms might invest directly in a third market to access another market in a region. This has been a feature of South Africa where a number of foreign firms have chosen to locate in order to operate elsewhere on the Continent.

  A larger market generates a greater scope for what is termed economies of scale (broadly, cost per units that declare with greater production volumes).

Localisation determinants are defined for resource-seeking FDI along:

(i) Real cost of the resource – the higher the cost the weaker the localisation influence;
(ii) Absolute scarcity of the resource – the more scare the resource, the stronger the localisation dimension;
(iii) When applicable: the relative productivity of the resource between regions.

Localisation determinants are defined for market-seeking FDI along the following elements in the host market:

(i) Absolute market size;
(ii) Market growth;
(iii) Advantage (comparative and absolute).

6.2 On Selected Specific Investment Determinant Elements

In this sub-section we unpack particular determinants of investment as requested for the project. We cover the following themes: administered prices, entrepreneurship and innovation before briefly shifting attention to access to capital.

6.2.1 Administered prices

6.2.2.1 Definition & context

An administered price is defined as "the price of a good or service as dictated by a governmental or other governing agency." A feature of these prices is that they "are not determined by regular market forces of supply and demand."[18]

Government interventions that take the form of lowering prices in markets reflect particular social welfare/developmental considerations; these considerations come into play in the protection of particular sectors or to ensure that the poorer people have access to a good or a service. When prices are reduced artificially through government interference, they cause, in a conventional context, an excess demand. That is, demand for a price that is lower than would be the case in a market clearing context, is above what is supplied.

Although other effects tend to result from a lack of competition that is generated from the control of prices by government, investments are curtailed: without subsidies by the state (which reduces resources available from other sectors), costs cannot be recovered in the protected sector and supply is rationed because consumers want more of a good than is available because of the low prices. Investment outside the sector is dampened if money is redeployed to production in the protected sector. Innovation is also likely to be stifled in under-resourced price-controlled sectors. This explains why price-controlled sectors exhibit very high prices when they are liberalized (yielding, in turn, high levels of inflation when large segments of an economy are opened up). This effect tends to be short-lived however as price only increases until resources are adjusted and properly re-allocated in the economy.

The situation is distinct for utilities (e.g. electricity, water, transport). Here the economic argument is one in which competition – in the form of many firms supplying the goods/services - cannot prevail naturally.

In a case in which the cost of producing an extra unit of goods declines and/or when adding users/consumers of a product/services generates additional benefits to existing users/consumers (e.g. in the case of bus transport system when bus riders benefit from a higher frequency of a bus service that is associated with additional bus rider users), there is the need/scope for government to interfere. This is because the service provider has, in these circumstances, the ability to set prices well above costs, making a very large profit along the way.[19]

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[18] Investopedia, available at http://www.investopedia.com/terms/a/administered-price.asp#ixzz3uDAwhMDD, retrieved 2 December 2015.

[19] These effects are described as economies of scale and network effects respectively and the type of situation described here is called a natural monopoly. A natural monopoly is associated with production costs being lower with one rather than many producers.

There are other cases for government to interfere in a sector but we do not discuss these here to keep the argument simple.

Note that costs per unit generally decline when the costs of the facilities required for production (these are the fixed costs) are high. Moreover, the larger the single producer in an industry, the more costly it becomes for a new additional firm to come in to produce/supply a similar good.

The point of the above is that administered prices are relevant to particular industries (e.g. network industries) where effective competition is not possible, that is under specific production conditions. Government interferes when a lack of competition would lead to particular distortions and to high prices that would be charged to users/consumers with adverse social welfare/developmental application and that are way above production costs.

Beyond the above context are cases where government takes over particular functions for the protection of individuals where minimum standards have to be guaranteed. This is the case for waste disposal.

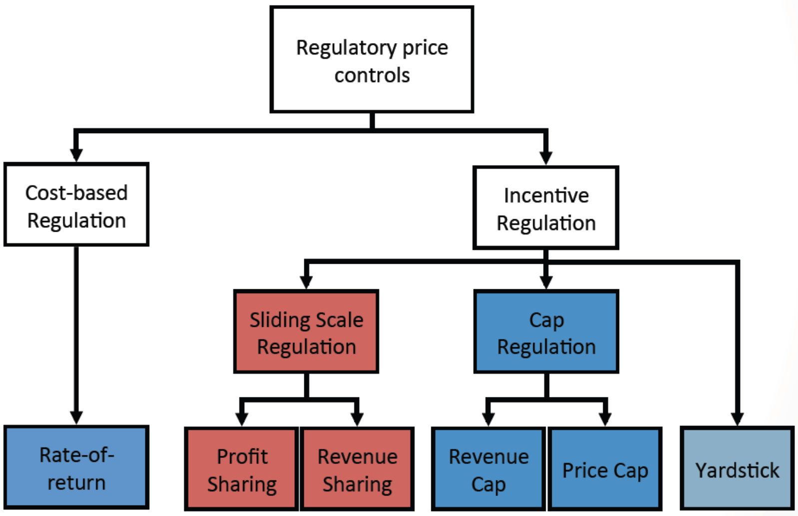
In the case of property development the state interferes to provide a critical mass of services (and related engineering support) that cannot be into place by a single individual (network effect). Also, there is a case for government to control negative externalities around land use, that is to control and/or address the adverse impact particular industrial or commercial activities might have on third parties. As such, land use and change in land use might need to be monitored or controlled by the state with fees charge for the evaluation of land use changes. The state also uses public land to reach particular growth and development objective; this is another case for intervention and land use/land use change monitoring.

6.2.1.1 Administered prices and impact on investments

6.2.1.1.1 General considerations

Price control by government in the special utility context set out above can take many forms. Figure 1 below represents the main approaches and options available to government.

Figure 1: Major price control models



Source: Bag (2013, p. 3)[20]

Each of the methods presented in the figure above has benefits and disadvantages. However, and although pricing methodologies can be combined, the point is that each of the major price method set out above has different impacts on investments in the regulated sector. Figure 2 below schematically represents these and illustrates that, for a number of price methods, there is an under-investment potential. This requires careful attention being paid to the authorities to the investment situation and decision in the regulated sector.

Figure 2: Impact on investment of the main price control models

Rate-of-Return	Potential of over-capitalisation inefficiently high capital-labour ratio
Revenue-Sharing / Profit-Sharing	Investment impact depends strongly on the design In general weaker (than rate-of-return regime) incentives for over-investment
Revenue-Cap	Potential of underinvestment Requires supplementary quality regulation
Price-Cap	Potential of underinvestment Requires supplementary quality regulation
Yardstick	Potential of underinvestment Requires supplementary quality regulation

Source: Bag (2013, p. 51)

Nothing inherently prevents investments in a regulated sector to be at levels that are

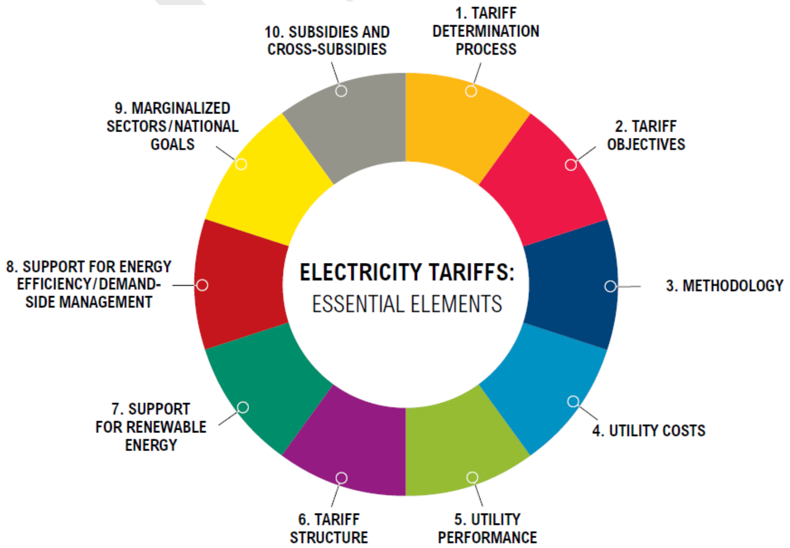
[20] Bag, S. (2013) "Natural Monopoly Regulation, Part III – Price Control Models", Lection 9, Economics of Regulation. India: Delhi, Delhi School of Economics.

below or above over what is required for the proper operation of the government company in a utility/network sector. Transparency, quick decisions and the right institutional and legislative environment all help ensure that the right investment decisions are taken. The authorities however have to recognize that there is risk of power abuse with room for prices to be set above the production costs and of the quality of the product/service supplied being sub-optimum due to incentive issues associated with particular type of price control regimes. Also, prices might be set too low when government officials use prices to derive political support from particular constituencies (e.g. from indigent people).

Finally government has to be clear about the boundaries of what it is that is being regulated and that ought to be regulated. Changes also happen over time which shape who has to supply the public goods/services. That means that the situation that applies to utility service provision has to be evaluated regularly with the private sector brought in when the case for the public intervention is not required; private investors can, for instance, be brought in along segments of the infrastructure (e.g. to share maintenance costs) once a network in place. Aspects of a regulated company that do not require government interventions can also be placed in the private sectors (e.g. the setting up of new meters, marketing, etc). While prices remain controlled, access to the infrastructure once set up can be opened up if it generates efficiency improvements.

As for what is happening to the economic activities generally, properly administered prices tend to help reduce uncertainty and attract investment.

Figure 3: Key elements for good electricity tariff determination



Source: Dixit et al. (2014, p. 3)[21]

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[21] Dixit, S.; Chitnis, A.; Wood, D.; Jairaj, B. and Martin, S. (2014) "10 Questions to Ask about Electricity Tariffs", World

Tariff setting is complex and needs to take many elements into consideration. (Figure 3 shows this and the main elements to consider in the case of electricity.) Of note on this is the fact that although economic regulation does not yield inefficient prices *per se*, it is poor price setting (including when the administered prices are to be increase) and poor price administration procedures that generate problems for firms that use the service/product. When prices are increased, when these increases are above of inflation and when price change decisions are taken in a non-transparent manner, particular problems emerge for firms that need to change their technology or investment type. Adjustment problems are pronounced moreover when changes do not coincide with particular phases of the business cycles that are associated with increased investment.

Special prices provided to particular consumers/users crowd-in investment on the basis of lowered production costs. But, since firms that benefit from the administered price (and in the extreme from subsidized prices) have limited incentives to progressively invest in resource-saving strategies, technological and other changes are slow to occur when prices are eventually increased, when the price increases are abrupt as well as when the decisions taken on price changes are not transparent. When administered prices are set in a complex and non-transparent manner, they cause a mis-allocation of resources and of investments.[22]

The outcome and problems set out above have been documented in South Africa: the country has experienced strong investment effects from administered prices in the electricity sector and from particular subsidies given to the large electricity users; historically, South Africa's industrial trajectory has been, for some researchers, grounded in the setting up, in the country, of large energy-intensive companies (including foreign companies) in energy-intensive sectors (e.g. steel or engineering which are electricity intensive).

6.2.1.1.2 Administered prices, Municipalities and their impact on investment

The South African government has recently paid careful attention to the situation with regards to administered prices in South Africa as a whole for a number of sectors: Detailed technical sector reports (for education, electricity, health, telecommunications, transport

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Resources Institute, Working Paper, Electricity Governance Initiative.

[22] A lack of transparency creates uncertainty for private investors, together with changes in rules and regulations around the sectors affected by administered prices. Moreover, when prices need to be increase they cause a decline in living standards - particular amongst the poorest consumers, and inflation pressures.

and water) are available at National Treasury on http://www.treasury.gov.za/publications/other/epir/ that comment on particular investment issues directly in the sectors looked at. Although, the aforementioned study does look into the impact of administered prices outside the sectors looked into, the Executive Report nevertheless makes the point that there are issues in the area of price setting. Thus, even though the rate of return approach is used in electricity and another specific price method is used *in parts* of the water supply chain:

> Although it is difficult to generalise across the sectors, it seems evident that in most sectors there is no systematic tariff-setting framework ….

More broadly the study warns that:

> In the utilities and transportations sectors, in particular, where planning cycles are relatively long, misleading price signals can lead both customers and service providers to make erroneous investment decisions at high cost to both themselves and to the economy.[23]

The following has been more broadly established with regards to the situation on utilities:

1. Administered prices (excluding fuel) are increasing at around 9%, a rate of increase that is above the inflation rate;
2. Municipalities have set prices in water and electricity to raise revenues. Currently electricity charges amount to between 25% and 35% of municipal revenues according the Department of Trade and Industry (**dti**, 2012).[24] On this, notable differences in terms of the prices charged to the users emerge across areas. Figure 4 below illustrates this with electricity at least for the largest South African municipalities.
3. Research has established that Municipalities have tended to under-budget for the maintenance and renewal of the infrastructure in a number of utility sectors.

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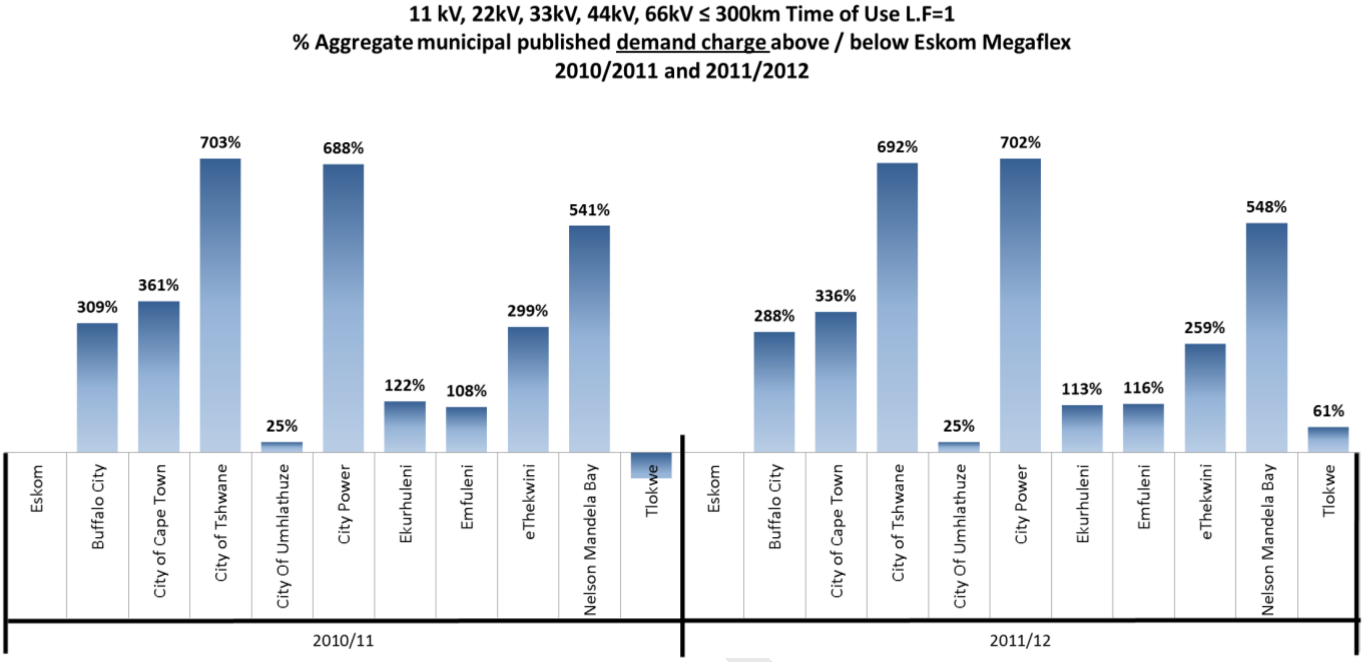
[23] Storer, D. and Teljeur, E. (undated) *Administered Prices – Executive Report*, A Report for National Treasury, SA, Economic Planning and National Relations, p. 38 and p. 42.

The following is added for electricity: "… The problem, however, is that low prices give conflicting messages to the demand and supply sides of the electricity market. Customers on the one hand are encouraged to invest in energy intensive appliances and equipment, while there is no corresponding incentive on the supply side to invest in increased capacity on the other. Security of supply will necessarily be put at risk if prices do not give broadly the right signals to both the demand and supply side of the market."

[24] Department of Trade and Industry (2012) "The Impact of Electricity Tariff Hikes on the Manufacturing Sector?", presentation to the Parliamentary Portfolio Committee on Trade and Industry, 31[ST] October 2012.

Figure 4: Municipal Tariff Margins above Eskom Megaflex in Selected Municipalities (2010/11 and 2011/12)



Source: DTI (2012)

Specifically, the following some key findings from the National Treasury Review and that are reported in Storer & Teljeur (undated):

- In electricity: "60% of the 177 municipalities supplying electricity have 'illegal' tariffs (tariffs that are not formally approved by the NER [the National Electricity Regulator]), highlighting the backlog in addressing municipal tariffs that the NER faces. Municipalities generally make substantial surpluses from their electricity distribution and retail activities, and even where formal surpluses are low, other municipal services typically benefit from shifting costs onto the electricity undertaking." The problem with the latter point is that "The finances of local authority distributors are not ringfenced from other municipal costs and significant revenue shifting is thought to occur." (p. 7)

- In the case of water: "Strong municipal and broader political pressure to limit retail water tariffs leading to a cost squeeze, which generally translates into insufficient investment and under maintenance. In this case *low* prices are not an efficient outcome and above-inflation increases would be economically efficient and promote better and more reliable service in the long run." (p. 24)

A cross cutting finding for water and electricity is that: "The lack of appropriate ring-fencing of accounts at the municipal level further aggravates the lack of accurate cost data ...." (p. 37). This would generally affect the investment decisions (level and location) by both, the public and the private sector in the Municipalities. A concern going forward is further with the need to significantly increase utility prices for investment and maintenance purposes. A wrong price signal means that investments are not optimum.

A number of the point raised above for utilities are further picked up in other areas of administered prices: in a draft SAPOA study[25] that analyses municipal fees that apply to property development and in another more comprehensive KZN study.

Although the draft SAPOA study only looks at the eThekwini Metro, Msunduzi local Municipality and uMhlatuze local Municipality in KZN from a total of 19 South African Municipalities, it finds the following, amongst others:

- That the fees for the submission of land use application are not uniform across municipalities. There are, moreover, variations in building plan submission fees;
- Consumption charges rely on complicated formulaes;
- That there are extreme variations in fees and more generally in the manners in which the fees are calculated;
- Town planning fees tend to be higher in the smaller than compared to the larger municipalities.

In fact, the study establishes that there is no consistency in the elements that form the basis of the town planning fees. In terms of building plan fees, those which refer to the surface of a building (m^2) as a fee setting criterion can generate extremely high building plan fees. Finally, a wide range of distinct criteria are taken into account across Municipalities in the establishment of fees.

All the above combines point to an uneven context in municipal fees for property development. This, which translates into uneven municipal service costs just for property development would influence property development costs and thus where new investors would locate and where new investment projects would emerge. Retail developers specifically bear the brunt of the selection of particular fee setting methods. However, there is a general lack of transparency on how various fees are set. In other words, municipal property development fees do not form an environment that is conducive to investment that relies on new property development.

Separately, the Province of KwaZulu-Natal (EDTEA) has recently, and together with COGTA, started to look onto the situation of administered prices for all public goods and services by the municipalities of KZN. The document produced to date is still in a draft

[25] SAPOA (February 2015) *Municipal Service Costs Analysis*, Draft Report.

form[26] but reiterates the points that: the tariffs for administrative goods and services do not reflect cost-setting principles; that different cost recovery models are used across KZN municipalities. The study establishes this for property rates, water functions, electricity and refuse. The absence of a proper administered price setting framework generally causes private sector resources to not be allocated properly.

Whereas the paper details the manner in which investors have been/can be attracted through particular municipal service incentives, concessions or relief, the paper draws attention to the risk of non-competitive rates from an investment perspective. Varied fees and rates and incentives/concessions produce an uneven investment attracting playing field. Rapid changes in the prices of particular utilities and the removal of concessions have penalized some large investors in the recent past moreover.

The paper identifies that inflationary increases, not the tariff modelling, influence the increases of administered prices. The paper also finds cases in which some rates are currently set at too low levels for optimal investments (including maintenance and repairs) in some sectors and in some municipalities: this is potentially the case for water in the Zululand District Municipality (and possibly Harry Gwala).

6.2.2 Entrepreneurship

There are numerous definitions of what an "entrepreneur" and of what "entrepreneurship" is about.[27] At its most basic however:

- an entrepreneur is someone who is involved with starting a new business venture;
- Entrepreneurship tends to be about "the dynamic process of identifying economic opportunities and acting upon them by developing, producing and selling goods and services". This is achieved by "marshalling resources to seize new business opportunities".[28]

When the terms are taken together, entrepreneurship tends to be about the young and thus smaller businesses (since firms which survive in a market environment during the

[26] EDTEA & COGTA (2016, forthcoming) Need for Uniform and Standardised Approach on Administered Prices for Public Goods and Services, Draft Discussion paper (January 2016).

[27] See Ahmad N. & Seymour R.G. (2008) "Defining Entrepreneurial Activity: Definitions Supporting Frameworks for Data Collection", OECD Statistics Working Paper STD/DOC(2008)1. Paris: OECD.

[28] These are recurring OECD definitions.

early expansion phase then grow as they get older up to a certain threshold). There are critical elements of risk taking in the definitions.

What the definitions also mean is that entrepreneurship is expanded in two ways:

- by helping unlock entrepreneurship from the perspective that is a key factor of a firm's development and survival (entrepreneurial capacity); and,
- by helping new entrepreneurs to emerge in an economy/area. The latter is particularly important in spatial areas that have a young unemployed population.

As entrepreneurs are directly engaged with *new* investment, enhancing entrepreneurship has important positive impacts on expanded investment (in the aggregate) as well as on innovation and technological progress. (In fact the concept of innovation is central, historically, to that of entrepreneurship as it is associated with innovation in the business sphere with innovative approaches deployed to exploit market opportunities.)[29] Also entrepreneurship development indirectly enhances investment by growing demand for goods and services.

Noting the general contributions of entrepreneurship to investment, entrepreneurship is also an outcome of investment and of the state of the various factors which influence investment and which we have presented in Section 6.1 of this report. This is an expected since entrepreneurship is, at its core, about the ability to control and organize productive processes under conditions of risk and uncertainty.

The issue of risk and the small or medium size of new businesses mean that entrepreneurship development of a large scale is required of the form of business expansion and retention (BR&E) support (presented briefly in Box 1 below). Box 2 below defines particular challenges on this in South Africa according to the Global Entrepreneurship Monitor (GEM).

Box 1: Business Retention & Expansion (BR&E) programmes

Business retention and expansion (BR&E) initiatives directly set external interventions in firms (e.g. training, additional funding, etc.) with the view to help these either survive or expand. BR&E initiatives form part of a strategy of entrepreneurship. Such strategy complements the development of new business opportunities but prioritizes supporting existing businesses in an area, typically *prior* to attempting to undertake large scale investment attraction of new enterprises.

[29] Entrepreneurial change is, in this framework, seen to involve: new/improved good being produced; new method of production; the generation of a new market; the exploitation of a new source of supply; and organisation change.

As entrepreneurs and entrepreneurship is seen as increasingly central to the health and growth prospects of an economy, BR&E is growing in importance as a field. Whilst BR&E seeks to facilitate economic development by creating a business enabling environment, it is not a conventional domain for policy-makers. BR&E tends to be driven by a Development Agency. This is because BR&E requires participation and a close relationship with the businesses that is being supported and with the broader business community.

Clear criteria have to be in place in the selection of who to support. Local business intelligence would be required for this.

BR&E tends to be costly as it requires specialists (e.g. value chain, financial, etc) with business and/or sectoral expertise. These experts are involved in developing action plans for the businesses that need to be retained or expanded.

Some of the BR&E activities are currently with the Small Enterprise Development Agency (SEDA) which offers support to SMMEs in partnership with banks. However, SEDA main role is in terms of providing information to small business and prospective entrepreneurs.

Box 2: Low Entrepreneurial Activity in South Africa

The Global Entrepreneurship Monitor (GEM) emphasised, pre-crisis, that South Africa had very low level of entrepreneurial activity. This position has remained low and was in 2014, at a "mere quarter of that seen in other sub-Saharan African countries", in spite of a high rate of unemployment. Entrepreneurial activity is currently at 7% and smaller new businesses have a very low rate of survival compared to what has been found in other countries.

While low entrepreneurialism is related to low saving levels - given the importance of personal capital as the main source of funding when starting a new business, access to finance is still a problem area. Entrepreneurship is constrained by education levels, government behaviour (bureaucracy), high levels of crime and onerous labour laws according to GEM.

GEM notes progress in women entrepreneurship which it attributes to government support but notes that "the perception of opportunities to start a business, and confidence in one's own abilities to do so, remains alarmingly low compared to other sub-Saharan African countries".

The typical South African entrepreneur is male, 25 – 44 years of age, lives in an urban area, is involved in the retail and wholesale sector and has a secondary or tertiary level of education.

In South Africa, a main issue with entrepreneurship is around the survival/ sustainability of SMEs.

Source: From GEM web-site (& other documents), http://www.gemconsortium.org/country-profile/108, retrieved December 2015.

But other themes and factors are pertinent when discussing entrepreneurship because the concept looks into the conditions of firm entry and into individual decisions that push self- as opposed to wage employment. These mean that the opportunity cost associated with the setting up a new firm, elements pertaining to individual abilities, resources, attitude, culture, etc. as well as prospects for the survival of small firms need to be looked into.

Figure 5 below reflects that entrepreneurship is associated with a distinct resource and capability set. For the the Global Entrepreneurship Monitor (GEM)[30] however, the two main conditions having an impact on entrepreneurial intentions are:

- Cultural and social norms (influencing entrepreneurship as a career choice);
- Education, including entrepreneurship education (owing to its impact on personal feasibility where entrepreneurship is concerned)

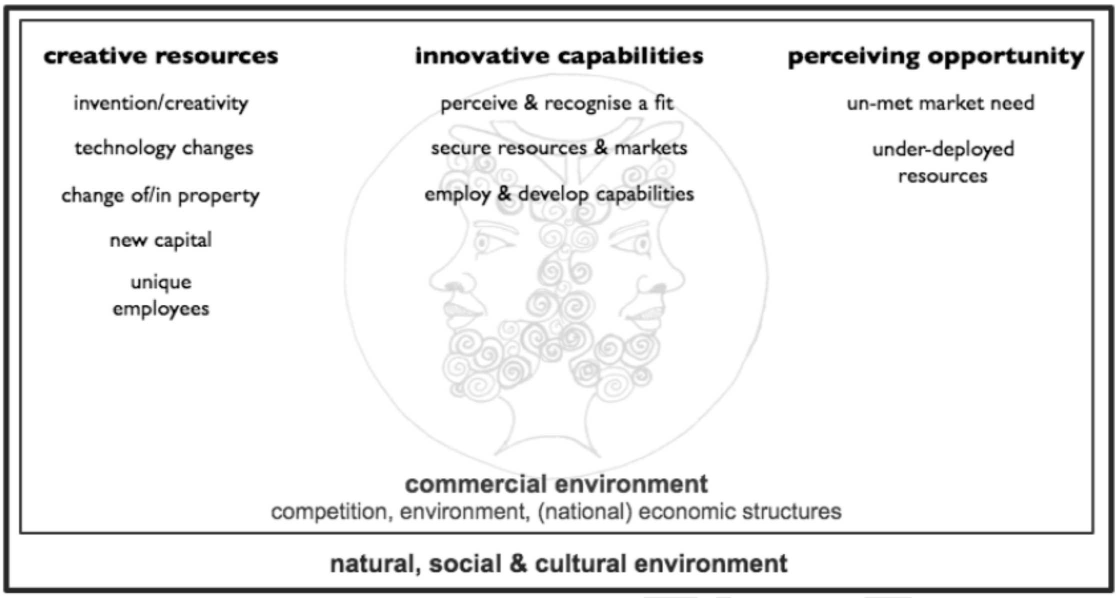
The following are the most likely elements that help transit entrepreneurial intentions to early-stage entrepreneurial activity according to GEM:

- Government policies in the form of entrepreneurship priority and support (registration of business)
- Finance
- Education (primary and secondary level entrepreneurship education)

With regard to the above problems in the area of access to finance are important as banks have become more conservative, "requiring more security and a longer track record which many start-ups do not have" since the crisis. Nevertheless, specific additional factors such as financial literacy have been found to be important as it contributes to the management of personal finances and business profitability. The latter is seen, by GEM, as an important problem area in South Africa in a context in which young entrepreneurs use domestic savings (see Figure 6).

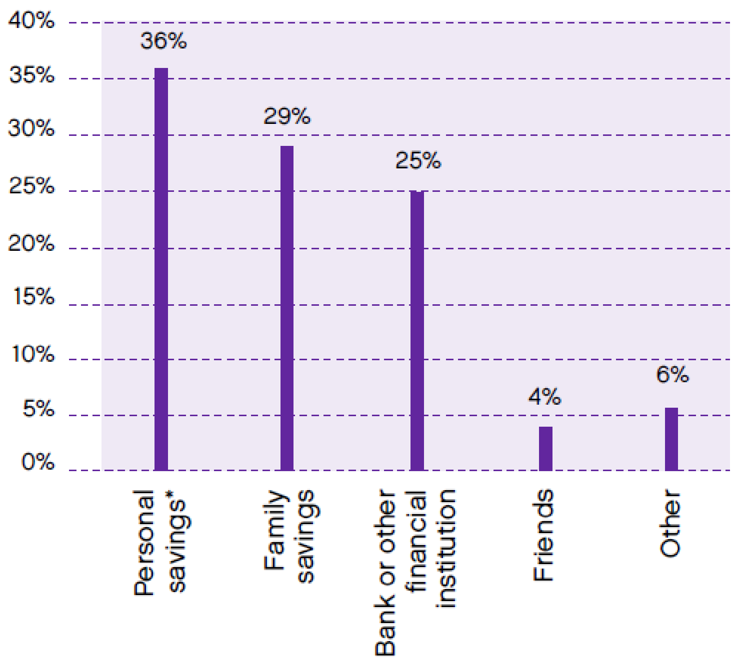
Figure 5: Entrepreneurial Activity in the Commercial and Wider Environment

[30] GEM (2012) *Global Entrepreneurship Monitor - South Africa*, report produced by Turton, N. & Herrington, M. UCT, GSB: GEM.



Source: Ahmad & Seymour (2008, p. 8)

Figure 6: Source of funding for youth entrepreneurs in South Africa



Source: GEM (2012, p. 71)

Zooming in onto some data helps unpack some issues for policy-making in the area of entrepreneurship. Table 1, which reports on the reasons for business exit in South Africa and how South Africa fares relative to sub-Saharan Africa (the column labelled SSA in the Table), one can see that issues of profitability are important reason for closure. This confirms that careful business planning needs to be given by the new entrepreneur as an investor. Security and individual conditions (in the form of incident and personal reasons in the table) are also higher in South Africa than elsewhere in sub-Saharan Africa. The latter emphasises that personal/individual elements are important. GEM (2014, p. 43) stresses for South Africa however, that

> A strong entrepreneurial culture cannot develop and flourish in areas with limited access to resources, poor infrastructure, little or no customer spend and no vibrant markets. In the absence of an enabling environment in which to utilise and develop their skills in practice, people will be forced to migrate/emigrate to a more favourable environment, search for formal employment within their current province, or remain unemployed. .... A more enabling environment is also necessary to reduce the cost of running a business ....[31]

In other words, the elements required for entrepreneurship are similar to those related to investment as discussed earlier but a well educated labour force and training is required for new businesses to emerge in the first palce.

Table 1: Reasons for Business Exit in South Africa compared to the 2014 average for Sub-Saharan (%)

	2006	2008	2009	2010	2011	2012	2013	2014	Ave SSA
Opportunity to sell	11,8	6,7	3,5	1,4	2,0	1,3	2,8	5,3	5,8
Business not profitable	11,4	31,3	26,0	24,4	32,6	28,7	36,4	42,5	27,7
Problems getting finance	32,1	29,0	27,2	39,1	24,0	28,2	28,9	19,4	20,8
Another job or business opportunity	4,3	6,8	6,0	0,9	6,0	5,4	2,9	3,2	6,9
Exit was planned in advance	2,7	1,0	0,0	0,0	0,0	0,8	1,8	0,5	3,4
Retirement	23,1	0,0	0,0	2,1	1,9	0,0	0,1	0	1,2
Personal reasons	14,7	21,7	21,0	15,5	15,6	19,8	23,2	19,9	16,9
Incident	0,9	3,5	6,4	1,9	0,4	0,6	3,9	9,21	7,08

Source: GEM (2014, p. 28)

6.2.3 Innovation

There are many types of innovation. These are:

- Product innovation, which is about improving existing product or creating new products. Such innovation, which is associated with enhanced competition;
- Process innovation which relates to a better use of the factors of production.
- Organisational innovation which refers to the manner in which firms or groups of firms are structured (e.g. clusters with group of firms that provide supportive services or goods that are used are input into other firms being located within in an area).

Innovation can involve new technologies and knowledge as well as a transfer/exchange of

[31] GEM (2014) *GEM South Africa Report – South Africa: The Crossroads – a Goldmine or a Time Bomb.* Available at http://gemconsortium.org/country-profile/108

knowledge with foreign firms tending to play a key role for this.

Broadly, innovation has impacts similar to those of entrepreneurship on investment by boosting efficiency and productivity. Of note is that innovation in the form of commercialised new products, processes etc. generate new markets when commercialized. These are new areas of investment. Innovation also accelerates obsolescence causing a churning in plant, machinery and equipment. Innovation also increases fixed investment in that manner.

Innovation processes entail, according to the OECD, four main activities:

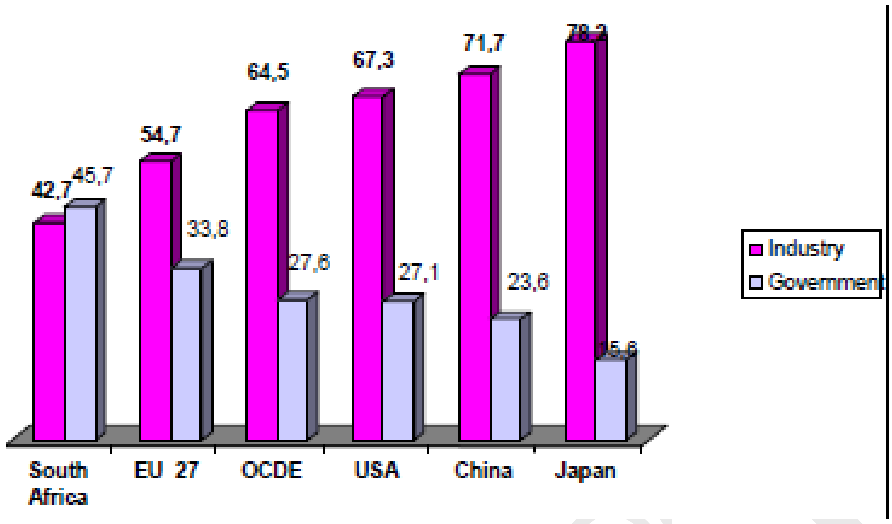
- Using innovations (adoption);
- Improving innovations (adaption);
- sharing or transferring innovations (diffusion); and
- the creation of new innovations (inventions).

As such innovation: relies on the development of soft infrastructure. Investment is framed by a concentration of skilled workers around a particular platform (e.g. an ICT platform) that acts as a catalyst for particular type of investments; it involves interactions between industry, communities and research institutes, where knowledge is required for the development of an innovation hub and for a proper deepening of innovation in particular are critical aspects of an innovation system however; Intellectual property and copyright protection has to be in place to support the generation of innovation.

A sound innovation system is required for innovation and for innovation to effectively spillover. Innovation, in turn, impacts positively on the investment climate at both, the firm and country levels. Innovation provides scope for a process of value-addition on products and services and help products become differentiated. Of note however is that innovation is not the sole domain of the private sector and government plays can play a particular role in this. Innovation by government can have overall efficiency enhancement (as set out in the cost of doing business) and helps strengthen the overall innovation system.

Data suggest that government has plays a critical role in creating new innovation in South Africa. Figure 7 reports the share in gross domestic expenditure on research and development (R&D) that is funded by government and industry in South Africa and in a number of other economies in 2007. The figure shows the strong role of government in such expenditure.

Figure 7. Percentage of Gross Domestic Expenditure on R&D funded by Industry (2007, %)

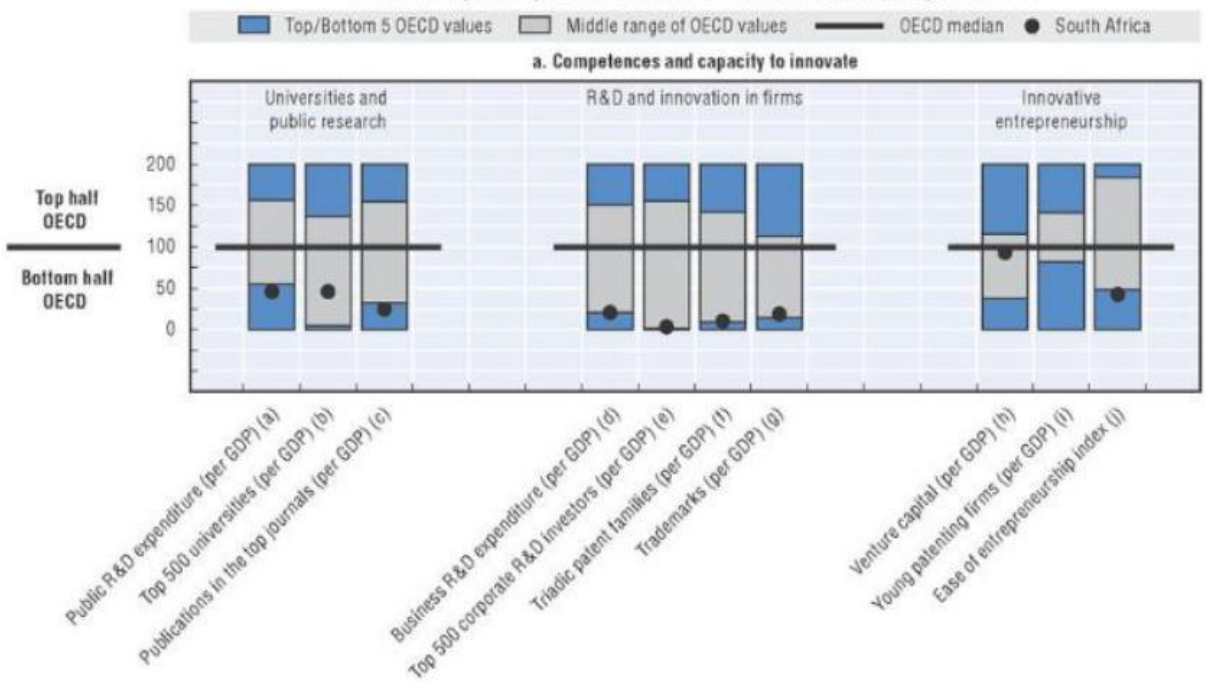


Source: SAccess (2012, p. 16)[32]

Nevertheless, South Africa confronts particular challenges in the performance of national science and innovation systems when compared to a number of other countries. Figure 8 shows South Africa's position in terms of elements of the national science and innovation systems that belong to "competences and capacity to innovate".

[32] SAccess (2012) "Supporting the EU access to South Africa's research and innovation Programmes", Report on South African research and innovation capacity, report produced through ACCESS4EU – South Africa, Contract Number 243851.

Figure 8: Science and innovation in South Africa - Comparative performance of national science and innovation systems for 2014 (index format relative to the median performer for the OECD area, median for the OECD = 100)



Note: Other elements not reported here are in terms of the Interactions and human resources for innovation.

Source: OECD (2014, p. 421)[33]

6.2.4 Access to capital - the role of global and financial markets in investment attraction

Savings are critical for investment and thus for capital formation. In fact, in a closed economy, savings would be equal to aggregate investments. What this means is that adjustments are, in this context, only reflected through interest rate changes.

In contrast to the theoretical case of a closed economy, economies have some degree of openness. This means that a country has the ability to borrow or lend from other countries. Actors in a country can also have (some) access to savings from abroad. Although governments' ability to borrow or to lend is distinct from that of firms, financial markets are important in this regards by getting savings to those that want to invest. The current account would reflect these transactions between two economies with a surplus reflecting an accumulation of foreign assets or a reduction in foreign liabilities.

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[33] OECD (2014) Science, Technology and Industry Outlook. Paris: OECD. Available on http://www.keepeek.com/Digital-Asset-Management/oecd/science-and-technology/oecd-science-technology-and-industry-outlook-2014_sti_outlook-2014-en#page420, retrieved 18 December 2015.

Internationally, economic actors' access to the financial markets in other countries is defined by administrative controls. These apply to moving money or funds aborad. When there is access to the rest of the world for borrowing and lending purposes, domestic interest are shaped by what is happening to the rates of interest in others countries.

When there is no or limited access, as through administrative capital controls, there is a loss of welfare – residents, when there is excess saving, face a decrease of the domestic rate of interest and an increase in that rate when they are credit constrained since adjustments of the current account are constrained. Capital controls on an economy are however useful to prevent savings from leaving an economy; when in place, capital controls help transform a rise in domestic savings into a rise in domestic investments. A context of control means that attracting foreign investment in a country, particularly in the form of FDI, is necessary to help expand fixed domestic investment.

Capital markets are one component of financial markets. In contrast to money markets being "used for a short-term basis, usually for assets up to one year", capital markets are "used for long-term assets, which are any asset with maturity greater than one year." Capital markets include the equity (stock) market and debt (bond) market. These markets "are often used together to manage liquidity and risks for companies, governments and individuals."[34]

Capital markets have certain features because of the roles risk and uncertainty play on them. In other words, when they are many capital markets, capital raised externally is not a perfect substitute for capital raised domestically. Differences between capital markets influence investments by influencing the cost of borrowing relatively. Moreover, availability of internal finance derived from a firm profit, by being distinct from other type of capital and because there tends to be an information gap between what is happening inside and outside a firm means that internal capital is different from other sources of finance. As such, internal capital, access to new debt or equity finance, and other financial factors, including access to capital markets outside an economy and the instruments on these markets all shape the decisions of individual firms to invest.

Empirical research has identified that financing constraints are determined by firm- and/or sector-specific characteristics that define risks, even within domestic boundaries. (Thus, more innovation-intensive firms and sectors have been found to face particular constraints.) This simply illustrates the importance of risk together with information by

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[34] Investopedia, Financial Markets: Capital Vs. Money Markets, available on: http://www.investopedia.com/articles/investing/052313/financial-markets-capital-vs-money-markets.asp#ixzz3ufO0T3MO, retrieved 16 December 2015.

potential lenders on the managerial capabilities and investment opportunities (the quality of risk). This is a negative element of global capital markets.

Of note in the market for credit is that the rate of interest is influenced not only demand for capital but also by the risk inherent with different borrowers. Bigger global capital markets can, as such, be more risky than a domestic capital market. In turn, recovery when an investment project fails is easier in a domestic-market context. This is another negative element of the global capital market.

In contrast to knowledge being more accurate in a national as opposed to international context, business knowledge and understanding of firms and of lending instruments is argued, by some, to be an advantage of larger capital markets that have been established for a long time and that are better experienced in screening out poor from good credit risks. Also, competition between markets, similarly to competition in the banking sector, expands innovation – at times expanding risk taking.[35] The very size of the global financial market means that a range of investment projects that can be supported, including very large private projects for which high levels of capital are required.

The state of financial development has been found to reduce the cost of external finance to firms, thereby increasing investments. It has also been found by expert financial researchers to be contributing to the impact of FDI onto the domestic economy by helping domestic producers expand on new opportunities and linkages with the larger player. Research is lacking on how the global financial market relative to the local financial markets tend to contribute to an expansion of fixed domestic investments specifically. Instead, research has tended to identify that larger foreign firms have an advantage in accessing capital through their own or larger financial markets.

The following tends to be generally noted as aspects of the global financial system that help expand investment:

- the global financial system is large and varied; it consists of many different types of financial institutions, as well as financial markets in stocks, bonds, commodities, and derivatives
- The global financial system promotes economic growth by:
    - facilitating risk management, enabling individuals and firms to be insured against adversity in bad states of the world, thereby increasing investment;
    - mobilizing resources globally and thereby improving the effectiveness with which local challenges are met;

[35] The investment attracted by any capital market is shaped by: (i) Systemic Risks – which have been reduced since the 2008 crisis; (ii) Efficiency (including reliable systems) & technology; (iii) Cost per transaction or per trade.

   - obtaining information for the evaluation of businesses and individuals and allocating capital, thereby overcoming problems of asymmetric information that make it difficult or costly for individuals and firms to obtain capital; and
   - increasing the set of opportunities available to companies, entrepreneurs, and individuals to participate in and contribute to global economic growth.
- The depth and liquidity of the global financial markets help companies reduce their capital costs, improve access to financing, invest more, and grow.
- Help to raise capital.[36]

Clearly issues of regulation are important for the above. Important weaknesses were highlighted in the 1998 and 2008 crises.

6.3 Evaluation of the Investment Context for Business

While the factors driving investment vary depending on whether macro-economic (e.g. growth) rather than micro-economic (e.g. at the level of firms) considerations are emphasised, the two spheres, that is the 'macro' and 'micro' sphere are connected. Work on the *Cost of Doing Business* illustrates the connection, emphasising that elements within the broad policy environment *through their impacts on businesses and business decisions*, can act as a constraint to investment expansion. Those concerned with such elements consider that these can impede growth and development. However, the elements of the *Cost of Doing Business* tend to bear on rules and regulations. They are thus only partially relevant when considering how to support investment in an area. Other elements are specific to competitiveness though the two cut across each other. We present these next but leave details for South Africa on these in Section 9 where key investment trends and patterns are set out.

6.3.1 The Cost of Doing Business: Elements Considered & Methodology

A number of elements that define the investment climate are the domain of the state. When these directly adversely impact on businesses (e.g. permits, regulations, etc.) will curtail investment. This is because in order to cover these external (not directly operation related) costs, an investor will require higher returns from an investment project.

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[36] Extracted in parts from: Thakor, A. (2015) "International Financial Markets: A Diverse System Is the Key to Commerce", Centre for capital markets competitiveness. Washington, Olin School of Business, Washington University in St. Louis.

High costs of doing business have a number of impacts on investment. These are:

- A bias in favour of large investment projects as well as a reduction in the number of investment projects. Larger firms tend to find it easier to absorb higher costs.
- A bias in favour of imported goods inducing greater competition domestically and economic vulnerability.

High costs of doing business have a higher impact on countries that have small markets and with poor population that rely on informal/survivalist activities.

A number of indicators are looked at as proxy for the investment conditions that relate to the performance of government in their interactions with businesses. In terms of the elements covered, these reflect the efficiency in some aspects of government support to businesses (e.g. time costs associated with particular activities such as the issuing of the licence). The *Cost of Doing Business* approach captures the impact of individual elements on businesses with each of the elements taken into consideration by the investors or in fact reflecting aspects of what is described broadly under the heading of the investment climate.

Table 2: Elements considered in Cost of Doing Business Surveys & Reports

Indicator set	What is measured
Starting a business	Procedures, time, cost and paid-in minimum capital to start a limited liability company
Dealing with construction permits	Procedures, time and cost to complete all formalities to build a warehouse and the quality control and safety mechanisms in the construction permitting system
Getting electricity	Procedures, time and cost to get connected to the electrical grid, the reliability of the electricity supply and the cost of electricity consumption
Registering property	Procedures, time and cost to transfer a property and the quality of the land administration system
Getting credit	Movable collateral laws and credit information systems
Protecting minority investors	Minority shareholders' rights in related-party transactions and in corporate governance
Paying taxes	Payments, time and total tax rate for a firm to comply with all tax regulations
Trading across borders	Time and cost to export the product of comparative advantage and import auto parts
Enforcing contracts	Time and cost to resolve a commercial dispute and the quality of judicial processes
Resolving insolvency	Time, cost, outcome and recovery rate for a commercial insolvency and the strength of the legal framework for insolvency
Labor market regulation	Flexibility in employment regulation and aspects of job quality

Source: World Bank (2016a, p. 20)[37]

The list of indicators considered in *Costs of Doing Business* is provided in Table 2. These indicators evolve to be improved over time. For instance, the benchmark was changed in 2015 to take into account how far apart countries are from each on the indicators.

Improvements relate to particular problems:

- issues of representation (when the firms that are approached in the process of information are not necessarily representative of what is happening in a country);
- the fact that the indicators (and the components that form the indicators) are aggregated with each of the component given a similar weight in the overall evaluation;
- the fact that the list of indicators/components looked at is not comprehensive (e.g. the *Costs of Doing Business* does not look into issues of reliability of electricity supply, the barriers to trade, the situation with regards to the availability of credit, etc.)
- The fact that numerous elements looked at in the *Cost of Doing Business* survey are not correlated with economic growth or other macro-economic factors that matter for growth.

In turn, the Cost of Doing Business is, clearly, not tailored to the conditions and priorities of particular economies. Yet, this is a strength of the *Cost of Doing Business* surveys together with a number of other advantages that are listed in Table 3 below.

[37] World Bank (2016a) *Doing Business 2016 Measuring Regulatory Quality & Efficiency*. Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank.

Table 3: Advantages and Limitations of the Cost of Doing Business Approach

Feature	Advantages	Limitations
Use of standardized case scenarios	Makes the data comparable across economies and the methodology transparent	Reduces the scope of the data and means that only regulatory reforms in the areas measured can be systematically tracked
Focus on largest business city[a]	Makes the data collection manageable (cost-effective) and the data comparable	Reduces the representativeness of the data for an economy if there are significant differences across locations
Focus on domestic and formal sector	Keeps the attention on where regulations are relevant and firms are most productive—the formal sector	Fails to reflect reality for the informal sector—important where that is large—or for foreign firms where they face a different set of constraints
Reliance on expert respondents	Ensures that the data reflect the knowledge of those with the most experience in conducting the types of transactions measured	Results in indicators that do not measure the variation in experiences among entrepreneurs
Focus on the law	Makes the indicators "actionable"—because the law is what policy makers can change	Fails to reflect the reality that where systematic compliance with the law is lacking, regulatory changes will not achieve the full results desired

a. In economies with a population of more than 100 million as of 2013, *Doing Business* covers business regulation in both the largest business city and the second largest one.

Source: World Bank (2016a, p. 22)

Going forward, the Cost of Doing Business will, amongst others:

- Incorporate more indicators of aspects of regulatory quality;
- Expand on the list of large cities to look at; the idea here is to show large differences and large scope for local government to replicate good practises from lessons when gaps are identified *within a country*.

6.3.2 Global Competitiveness

Elements that relate to the broader investment context and to the quality of that context are captured by the World Economic Forum. As typical of many international organisations, the World Economic Forum collects similar data across a great number of countries. *Global Competitiveness Report* last collected and processed data for 140 economies. Cities have also, since 2005, been specifically scrutinized.

The comparable data are compiled and presented in an annual *Global Competitiveness Report*. Data on individual indicators are combined to generate a Global Competitiveness Index (GCI), a comprehensive tool that gives a sense of national competitiveness in a relative context. The indicators considered are those that are associated with the microeconomic and macroeconomic foundations of competitiveness by the World

Economic Forum.

6.3.2.1 Pillars of competitiveness in the Global Competitiveness Report

While the objective of the *Global Competitiveness* is one of identifying the best strategy to enhance competitiveness and of improving the policies required to tackle competitiveness improvement obstacles, the approach also relies on identifying specialization so as to help drive investment further. In other words, investment and growth are key considerations of the *Global Competitiveness Report.*

Competitiveness here is defined as "the set of institutions, policies, and factors that determine the level of productivity of a country." Productivity is critical in the approach as it "determines the rates of return obtained by investments in an economy" (World Economic Forum, 2014, p. 4)[38].

Figure 9 reports the key determinants (pillars) of competitiveness in the *Global Competitiveness* Framework. As can be seen from the figure, particular elements that form competitiveness are emphasized under each pillar. These elements are distinct, in many cases, from those looked at in the *Cost of Doing Business* exercise. Thus:

- for infrastructure, not only is transport infrastructure important to move goods, telecommunication infrastructure is also seen as a critical aspect of competitiveness. Electricity supply, specifically in the form of the reliability of that supply, is looked at in the analysis and production of the overall CGI;
- Labour market efficien is a particular pillar that refers to both, the efficiency and flexibility of the labor market of an economy. Gender equity elements are also considered in the analysis in this regards.
- Innovation is a pillar that is considered separately in the Global Competitiveness analysis from technological readiness and from business sophistication. Technological readiness is about the agility in the adoption of existing technologies, even of those that are not always available in a particular country but can be acquired, instead, outside of a country's geographical borders. It is, therefore, treated as distinct from innovation. Business sophistication is defined along "the quantity and quality of local suppliers and the extent of their interaction" (World Economic Forum, 2014, p. 8). Interconnected defines the presence of clusters and the indicator on this would thus take into account their

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[38] World Economic Forum (2014) *The Global Competitiveness Report 2014–2015: Full Data Edition*. Geneva: World Economic Forum.

positive effects (e.g. efficiency) on competitiveness and investment. In parallel, the advanced operations and strategies (branding, marketing, distribution, advanced production processes, and the production of unique and sophisticated products) of individual firms in their spill over effects also fall under the heading of business sophistication.

Figure 9: The GCI Framework – The 12 Pillars of Competitiveness

Source: World Economic Forum (2015, p. 3).[39]

6.3.2.2 <u>*Pillars of competitiveness & Economy Type*</u>

The pillars, as these are set out above, coincide with a hierarchy of development phases which we touch upon next.

As expected the pillars refer to elements that are inter-related; aspects underlying the performance of particular pillars are likely to be related with indicators used in other

[39] World Economic Forum (2015) *The Global Competitiveness Report 2015–2016: Highlights*. Geneva: World Economic Forum.

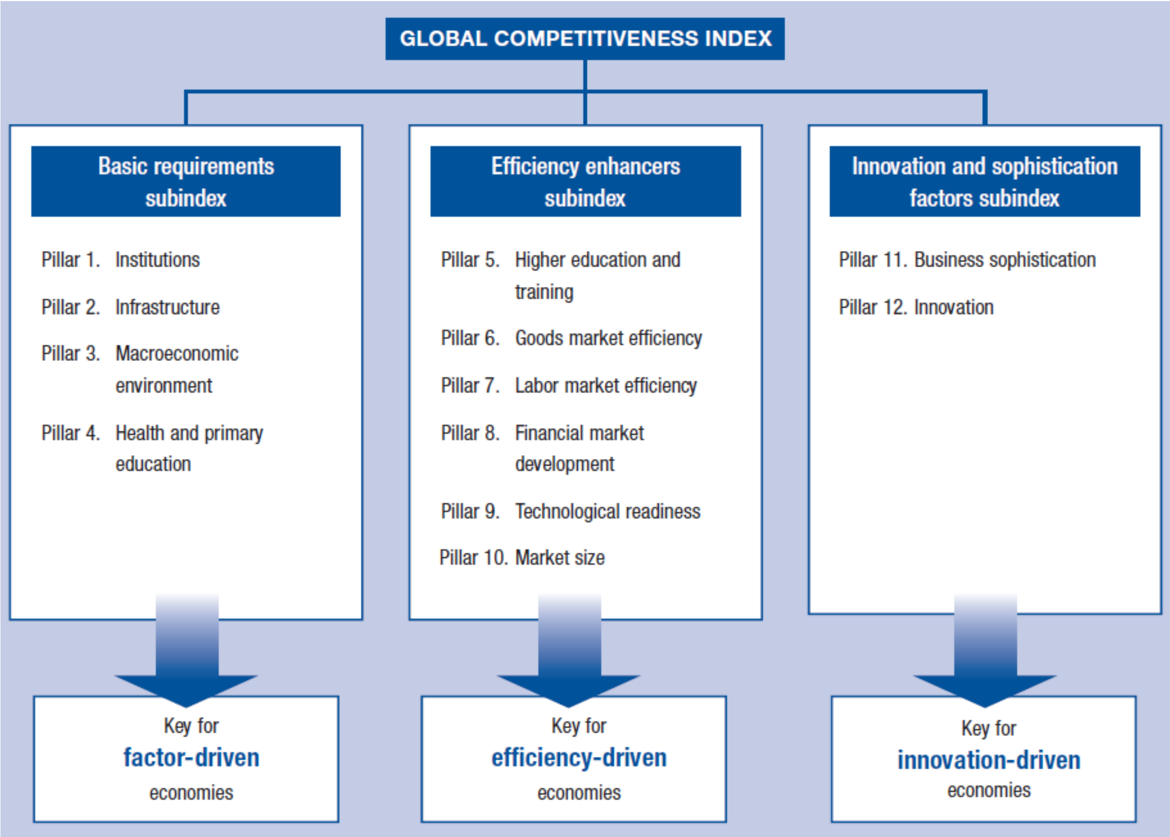
pillars by the nature of growth. However, a distinction between the *Global Competitiveness* approach and that of the *Cost of Doing Business* is that different weights are attached to particular pillars. Thus some pillars, like financial market development have a weight of 17 per cent compared to the weight given to institutions and which is 25 per cent. This reflects the different impact that some pillars appear to have on overall competitiveness.

In turn, particular elements that form the overall performance of a pillar are seen to be more important than others in that performance: elements pertaining to public institutions are given a weight of 75 per cent while those pertaining to the private institutions are given a weight of 25 per cent. As for the weights given to innovation and sophistication factors they vary depending on the level of development of an economy. The lower the level of development in GDP per capita bands, the lower the weight given to that pillar.

In fact, groups of main pillars are given different particular weight, depending on GDP per capita thresholds. Figure 10 below reports how groups of Global Competitiveness Framework pillars matter for particular phases of development.

Three main phases are considered by the Global Competitiveness Framework. These represent how various types of activities would evolve as an area develops. Thus, financial development matters less for the competitiveness of the poorest than for the competitiveness of middle- or upper-income economies. Innovation matters more for upper-income countries. These, which define some priority areas for national policy makers, need to be considered together with the discussion laid out earlier on specific elements driving investments. The approach also points to a lack of connection between innovation and entrepreneurship.

Figure 10: The Global Competitiveness Framework and Developmental Stages



Source: World Economic Forum (2015, p. 9)

6.4 Implications of the determinants of investment for DMs and a DMIPFS

There is a long list of determinants of investment. What is important is that all the elements as a whole would be taken into account by private investors in their investment decisions and for an expansion of fixed investments in an economy. Foreign investors who are more footloose would look at these relatively, that is by comparing countries though particular type of FDI might just rely on a few key elements such as the presence of a particular resource (e.g. mining).

Although researchers continue to seek to identify which determinants are important on the ground, these have been found tend to vary across countries and regions, at times in a non-consistent or easy to interpret manner. Moreover, even when looking at a particular country, the findings from data analyses tend to vary depending on the methodology deployed. Theories thus continue to drive the elements to consider to boost investment. In this regards, saving is critical for investment. Growth however, defines new investment opportunities.

The fact that growth is multi-faceted explains why international organisations tend to consider a wide range of indicators when evaluating some large categories of factors that influence investment. Some key elements of growth are shaped by particular policies and the policy environment; the quality of institutions and the rules and regulations in place are critical for investment together with the view which government has of the business sector.

Other factors, which when changed, positively impact on the production conditions are those that affect either the cost of production or the prospect for new production such as infrastructure. Education and skills influence both the cost of production and new production (goods and markets) opportunities. Government in its policies and interventions can have a strong influence on these.

The fact that numerous elements form the basis of what is described as the investment climate creates a challenge for local policy-makers because a number of these elements are defined and shaped at a national level, not at a local level. Yet, a local investment strategy needs to take account of the weaknesses that prevail on particular dimensions *nationally* and recognize that these will act at constraints to investment.

Separately, we have laid out some determinants can be influenced at the local level. These include:

- The provision of soft and hard infrastructure/infrastructure development. Serviced land has been found to be important for businesses;
- Entrepreneurship which, because it relies on shaping the intentions and/or performance of individuals with particular socio-economic characteristic, can be enhanced locally.

Local government can, in turn, also help address elements that shape uncertainty; transparent procedures, rules and information will:

- help reduce the cost of doing business and thus business performance at the local level.
- They also matter to help transform entrepreneurial intentions into action.

Streamlining bureaucracy and a quick turnaround on decisions that affect businesses are also important as captured in miscellaneous indicators of the *Cost of Doing Business*.

The discussion on administered prices is shallow but serves to illustrate that administered prices are not inherently investment-distorting. This is a large theme that clearly deserves detailed consideration of its own. For the purpose of this report, we only *touch* upon the situation in South Africa here but highlight that research suggests that while there is scope to engage with expanded investment around the provision of water and electricity, price increases in excess of inflation in these sectors should be anticipated.

These increases would affect the cost of doing business and the competitiveness of particular sub-regions. These challenges offer new opportunities however, even though the discussion has also shown that municipalities might be challenged in terms of securing extra revenues through increasing the cost of electricity and water further.

Municipalities will have, in the future, not only to anticipate continuous adverse price developments and engage with the businesses affected by high price increases going forward, they will also have to make room for investment to expand in the area of resource-saving. The point about electricity is that it is electricity reliability (the quality of electricity supply) is one key element of global competitiveness.

While education and skills development tend to be national rather than local matters, there is room to enhance savings to be released for the emergence of small businesses at the local level. There is also scope for local government to support particular types of innovation. Product and process innovation that engages R&D tends to rely on the presence of tertiary institutions that tend to locate in larger economic centres. Still, innovation can take place around encouraging investments that rely on a good telecommunication infrastructure (e.g. ICT) if such infrastructure is in place.

South Africa performs relatively well in some aspects of innovation. However, innovation is concentrated in larger economic centres.[40] This is because it is in these areas where there is a critical mass of firms, where higher skills workers tend to be present and because innovation requires partnerships with research institutions/bodies that tend not to be present in the less economically active areas. Worryingly, South Africa does not seem to fare well with regards to a number of elements that define its system of innovation.

With the focus on the impact of innovation on investment in this situation analysis report, we have simply highlighted that:

(i) innovation is a driver of technological changes and thus that innovation as a whole is closely related to an expansion of fixed investment which involves an expansion of fixed physical capital; and,

(ii) that innovation is inherent to entrepreneurship.

Innovation is heavily driven by government in South Africa but this is an important

[40] Government investment currently plays a key role in terms of investments in R&D in South Africa however.

element associated with encouraging FDI as foreign companies tend to bring special know-how and more advanced technologies than available in the national market. Linkages with domestic firms matter however for knowledge sharing together with the type of FDI that takes place.

There is, in turn, large scope to develop entrepreneurship significantly. Better and a greater mass of entrepreneurs would expand investment. Local government will have to be cognisant of the fact that there is a spectrum of entrepreneurs in an enhanced entrepreneurship development strategy (potential, intentional, nascent, new, and established entrepreneurs).

Specific training might have to be pushed to enhance entrepreneurship. As noted above, training tends to be an area of national policy-making. However, partnerships with established business or with local banks or other experts for dedicated training for formal SMEs can be put into place or deepened. In turn, a clustering of economic activities, which include the provision of industrial estates with serviceable sites, financial assistance, and consulting services can help boost entrepreneurship by deepened the linkages between firms are and/or by allowing new opportunities to arise for new and smaller firms.

Entrepreneurship development is important to help address youth unemployment and the migration of those that are more skilled from less to more active economic centres. One aspect that helps entrepreneurship is with ensuring that entrepreneurial intentions are turned into actions. Innovative solutions should be unlocked at the local level for this.

Entrepreneurship and innovation might require more or new institutions to be set up or supported along the way.[41]

Since we do not return to the theme of entrepreneurship elsewhere in this Part 1 of the Situational Analysis, we highlight that government support might need to be seriously improved in this regard in South Africa.

Figure 11, while only reporting results for the province of the Western Cape, shows that many elements that would support entrepreneurship are currently rather severely lacking at the local level.

Figure 11: Assessment of Municipalities in the Western Cape from an Adult

For each statement below, indicate which of the following best represents your opinion about the statement
1 = strongly disagree; 2 = disagree; 3 = not sure; 4 = agree; 5 = strongly agree; DN = don't know; RA = refused to answer

Response	Assessment rating
The local municipality has an effective small business support centre	1.4
The local municipality offers sufficient good quality trading space	2.7
The local municipality offers an efficient business licencing service	2.9
The local municipality is efficient in its procurement promotion	2.3
The local municipality is efficient in all its dealings with small business owners	2.5
The local municipality is better managed than neighbouring municipalities	2.8
The local municipality is trustworthy	2.8

Population Survey – Rating over elements, 2014

Source: GEM (2014, p. 41)

To further note is that there are important differences in the support that is potentially required in unlocking entrepreneurship in the rural areas and in unlocking the right opportunity: 46 per cent of the KZN's early-stage entrepreneurs are found in its rural compared to 48 per cent in metropolitan areas (GEM, 2012, p. 44).

Positively, around 23 per cent of South Africa's early-stage entrepreneurs are in KZN (GEM, 2012, p. 43). The province has an above average ratio of entrepreneurs relative to its population.

7 ELEMENTS RELATED TO INVESTMENT ATTRACTION & RETENTION

We set out in a discussion of the key elements that matter for investment attraction and retention in what follows. We note from the onset that one caveat with work on this topic internationally is that it tends to focus on FDI. We consider that the points raised for FDI are applicable for domestic fixed investment although investment retention which are more critical to the smaller younger domestic firms than to other firms is somewhat weakly considered in international references.

The discussion of investment promotion and facilitation that we present not exhaustive given that it falls in the business domain. Moreover, a number of toolkits are available for policy makers to help concretely unlock investment and to focus on the key elements required to service the investors through an agency. These toolkits are available on the web-sites of a number of international organisation but detailed course modules are available on the following World Bank web-site: www.wbginvestmentclimate.org

7.2 What is Investment Promotion and Facilitation

Investment promotion and facilitation tend to be considered together in discussion of best practices. However, they have different objectives and, as such, they are about different activities:

- Investment promotion is about attracting investment;
- Investment facilitation is about "providing potential investors with the information and assistance needed to make an informed location decision" in an environment that competes to attract the investors. The assistance referred to here is that

required to facilitate the start-up of new domestic and foreign firms. This is about transforming a potential into action. Moreover, investment facilitation refers to services that help keep firms in operation.

Both above dimensions are a key role of investment promotion intermediaries, with a number of these intermediaries being agencies (investment promotion agencies or IPAs).

The above definitions put a particular emphasis on the main elements that need to be looked at when evaluating performance and defining best practices and these are about providing the right information and presenting an economy (country or region) positively.

Because facilitation services are about ensuring investor satisfaction, it means that the strengths of an investment environment have to be emphasised. It also means that agencies involved with investment promotion and facilitation activities have to be cognisant of the weaknesses of that investment environment and help address these together with other.

One element within facilitation is that of after-care. Aftercare is, broadly, about ensuring satisfaction beyond the setting up phase.

7.3 Best Practices

7.3.1 Establishing Best Practices

There is limited research in terms of whether particular type of investment promotion and facilitation arrangements fare better than others with the exception of a recent study that has found a positive link between the quality of investment promotion and facilitation agencies and FDI inflows.

A problem in terms of establishing best practice is in the difficulty of addressing the question of whether or not an investment would happened without promotion and facilitation. Noting this difficulty, the approach has evolved away from drawing case studies from a number of IPAs and of gathering particular indicators of operation, organisational structure and performance from these;[42] towards the late 2000s more

[42] UNCTAD used this approach at the end of the 1990s – see (1997) Survey of BEST PRACTICES IN INVESTMENT PROMOTION. Geneva: UNCTAD, Division on Investment, Technology and Enterprise Development, Advisory Services on Investment, and Training – ASIT, UNCTAD/ITE/IIP/1.

quantitative base approach emerged in the assessments of investment promotion intermediaries. The approach is simple and suited to quick and easy evaluations.

The approach, adopted by the Global Investment Promotion Best Practices (now GIPB formerly, Global Investment Promotion Benchmarking) is streamlined. It considers: (1) web-sites and (2) responses to queries to two investors (in agri-business and in tourism) making queries. A grade is given on the performance of IPI (investment promotion intermediary) for each of these elements. The grades are them combined with equal weight given to each aspect of promotion and facilitation as both are seen as equally important. While the GIPB recognises that responses to queries might be influenced by the financial conditions and resources of an agency, aftercare is not yet a central aspect of the GIPB activities.

7.3.2 Best Practices in Investment Promotion & Facilitation

The GIPB approach, as set out above, does not critically distinguish between investment promotion and investment facilitation in its report. This is because the key characteristics of promotion and of facilitation is about customer-orientation and preparedness.

Anticipating customer needs requires, however, information on the economy, including information on how various sectors fare. In the process of evaluating an investment project, data are used by the potential investors in their cost benefit analysis and investment plans. They thus need to be accessible. Web-sites re the first data source consulted for this. As such, the quality of web-site is important. This quality is defined over: clarity, ease of use, comprehensiveness, contained accurate information, etc. The web-site also needs to clearly redirect to the relevant IPA staff when appropriate.

In terms of web-site, GIPB suggests that background research of the type set out in Figure 12 is essential. GIPB provides detailed information on each aspect of what a good web-site is about in separate materials on its site.

Figure 12: Research steps to building a good IPA web-site content

Source: GIPB (2102, p. 19)[43]

Past website content check and probing, investors will engage with staff in an IPA. These, when contacted need to be professional and engaging. They need to be able to answer a number of key questions about government strategies, policies, etc. Staff has to be knowledgeable, not only on the national and on the local context but also on the context of other areas given that there is competition for investors.

For both investment promotion and facilitation, staff have to respond to queries quickly. A difference with communication is however between the promotion and facilitation stage. Promotion relies on presenting a positive image of an economy. Details are to be set out on profitable investment opportunities and on local partners amongst other.

The following but include the following are consistently set out as early steps to follow in the unlocking of an investment promotion strategy:

1. In terms of strategy, staff at IPAs need to understand the priority investors around which to focus promotional efforts. What is to be achieved by attracting investment needs to be clearly defined for this together with the strengths and weaknesses of an investment region/site. This is about understanding the location
2. Identify targeted industries and location. This is important in order to develop a marketing strategy that is tailored to the specific requirements of companies in the targeted industries.
3. Develop a marketing strategy. This is about unpacking the manner in which potential investors will be approached or engaged.

The above are aspects that are institutional in nature.

Concrete and practical dimensions are drawn by GIPB (2009) in a survey of 96 IPIs. This survey drew the elements that set the best from the weaker facilitators apart. The following are a subset of the steps specifically identified by GIPB for an IPA to excel in customer service:

1. Build a staff with public and private sector experience.

[43] GIPB (2012) *Global Investment Promotion Best Practices 2012* - 2012 Investment Climate. Washington, D.C.: The World Bank Group, Investment Climate Department of the World Bank Group.

2. Offer good remuneration, that is remuneration that is close to private sector standards.
3. Secure operational freedom and high-level reporting channels;
4. Establish and concentrate efforts in a few priority sectors;
5. Coordinate facilitation with networks and other partners nationally and overseas;
6. Maintain English-speaking staff in sufficient numbers and with the full range of facilitation skills;
7. Establish a minimum level of in-house research capacity;
8. Develop account managers into reservoirs of knowledge on particular sectors
9. Make facilitation a priority within the overall strategy, including by training and dedicating an adequate proportion of staff;
10. Maintain the equipment and practices to be easily reached and to quickly return calls and e-mails.
11. Demonstrate professionalism and dynamism through the Web site with frequent news updates of importance to investors.
12. Follow detailed guidelines on the content, style, timeframe, and quality assurance of inquiry responses.

7.4 Role of the public sector as an investment promoter and facilitator

Government is typically (though in a number of cases in partnership with the private sector) involved with promoting and facilitating investment. This role is associated with the importance of investment for growth. It is also associated with the fact that there is currently intense competition in attracting the subset of foreign firms that want to set up abroad. Finally government plays a key role in addressing the problem of an under-performance of economic activities in some regions or nationally. In the case of regions the motives that drive promoting and facilitating investments are similar to those that underlie local economic development. Noting this broad role, we focus in what follows on the role of development agencies and of zones. Government drives both of these in South Africa and elsewhere though government's role in IPAs is associated to an information problem of some form which means that it is not optimum to have IPAs fully managed by the private sector.

7.4.1 The role of development agencies in attracting investment

Development agencies are conceived in the context of local and regional authorities playing a key role in stimulating, organising, supporting and promoting economic development. This is achieved by fostering the activities of local institutions/associations and by integrating the activities of these institutions/associations with a focus on particular objectives that reflect specific developmental priorities (e.g. the development and promotion of SMEs, of entrepreneurship, innovation, etc.) as well as the broader objective of improving both, the economic context and set of opportunities at the local level. Typically, a local economic development agency would seek, according to the World Bank, to promote competition while unlocking opportunities for those that are the most vulnerable.

Development agencies play a key role in catalysing investments that are suited to local conditions:

- Through their ability to implement projects and to provide services and credit;
- By acting as a forum for social dialogue although some emphasize that local development agencies' key role is more specific and profound and that these are to help co-ordinate stakeholders so as to achieve social cohesion;
- By assisting investors. On this the World Bank notes that a core characteristic of local economic Development Agencies is to assist launch an entrepreneur by helping him/her articulate a good idea, develop a business plan and ascertaining the feasibility of the business plan. Development Agencies would also help with credit.
- By promoting small producers' access to the market.

The above list is not exhaustive[44] but serves to highlight that development agencies are critical investment facilitating entities.

7.4.2 The Role of Special Zones

Governments have sought for almost a century to attract foreign investors in their

[44] See http://info.worldbank.org/etools/docs/library/166856/UCMP/UCMP/7 leda.html for a list of core characteristics of local economic development agencies as defined by the World Bank Group from which some of the above points are drawn.

countries and in particular areas within countries through geographically bounded incentives/incentive packages. These are special zones.

Special zones grew in number over the late 1980s and, by the mid-1990s, around 88 per cent of developed and 60 per cent of developing countries in a large survey conducted by UNCTAD had special economic zones (SEZs). By the mid-2000s, around 3 500 zones were recorded internationally with 4% of these zones in Sub-Saharan Africa. The zones take a variety of form (e.g. parks, export processing zones, etc.)

A number of problems were identified around these, but of note was a disconnection between foreign and domestic firms to such an extent that these areas were described as "enclaves" limiting the benefits of FDI to job creation; this separation was particularly evident in export processing zones which tended to attract foreign firms solely on a labour cost advantage basis.

Requirements then became a more prominent aspect of these zones, associated with governments specifying particular actions and activities (e.g. training of the workforce). Also host country governments brought domestic firms into such zones, provided certain conditions or criteria were met, so as to deepen the developmental impacts of the foreign firms. In spite of these changes, the International Finance Corporation (IFC)[45] still recently found little linkages between domestic and foreign firms in these zones though they have been successful in employment creation and in generating a new growth trajectory away from agriculture, particularly in the case of export processing zones.[46]

Contextualising the objectives of special zones, and ensuring their effectiveness in relation to key government objectives has been a challenge for policy-makers.

Research[47] has shown that the investment climate is critical for SEZ performance with a strong link moreover, between national investment climate and national competitiveness. Within an SEZ, transport and trade facilitation and infrastructure quality are the factors that appear to have a strong effect on performance. Specifically, it is "the provision of serviced industrial land infrastructure and relatively reliable supply of power" that is emerging as a key determinant of the success of these zones. This is about infrastructure reliability. Interestingly, infrastructure has emerged as significantly more important than

[45] This is the largest global development institution in the World Bank Group focused exclusively on the private sector in developing countries,

[46] This is for a number of reasons but include: Differences in trade regime/arrangements which still prevail between the two types of firms; and, Bureaucratic hurdles around VAT arrangements and exemptions. In this context, the problem remains one of ensuring linkages between the two types of firms.

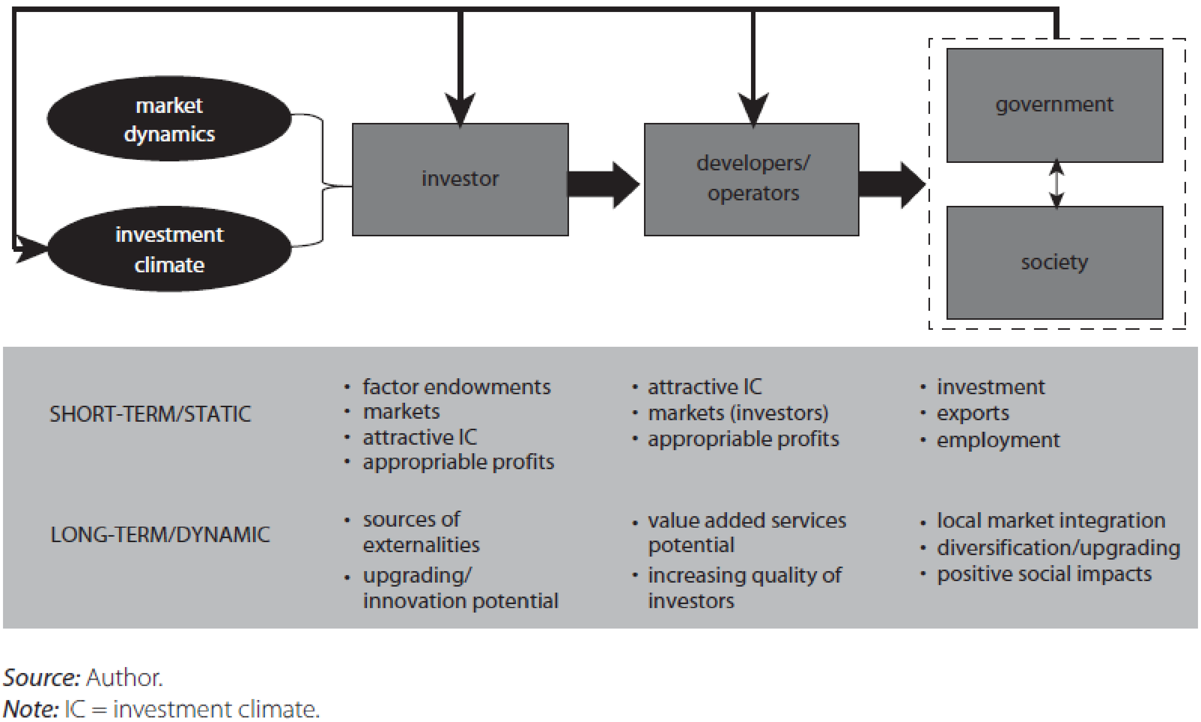
[47] See Farole, T. (2011) *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences*. Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank

incentives in a number of surveys looking into factors attracting investment.

Finally, research has showed that resources and the capacity of the authority responsible for developing, promoting, and regulating the SEZ programme influence the success of a SEZ programme. Farole (2011) from the World Bank and in a large evaluation of SEZs showed that it takes around 6-7 years for exports to grow in EPZs.

Figure 13 below reports the elements that drive SEZ performance in the short and in the long term. Long term effects are those that are related to a broader transformation of economic activities through large scale competitiveness type effects. Short term static effect are simply about the economic zones as capturing specialisation gains and as instruments of trade and investment policy.

Figure 13: Framework for Assessing the Outcomes of Economic Zone Programmes



Source: Farole (2011, p. 63)

At the national level, SEZs' developmental contributions require broad policies that:

- Promote skills development, training, and knowledge sharing;
- Promote industry clusters;
- Support the integration of regional value chains; and
- Support public-private institutions, both industry specific and transversal.

8 South Africa and KZN: The Investment Context

Having relayed a number of elements that pertain to the investment scene, we now shift attention to detailing the national South African and then the KZN investment context.

This particular section is policy-focused and emphasises how investment is framed through policy, the justifications for the policy lens and the main instruments which are in place to support foreign as well as domestic investment. This section is important for a DMIPFS because investment promotion and facilitation at the local level need to lever national policy elements and because the manner in which policy makers define the role of investment for the country defines how provincial and local level can help support or complement that role. In fact, the discussion shows that enhancing investment is a key concern of the main policies and actions in the countries and that a range of support actions are in place to help influence investment levels. Dynamic effects tend to be taken into account in this regard. A recurring theme of policy documents is that investments are currently low in South Africa.

8.2 The national policy environment: South African Key Policies and Actions

8.2.1.1 <u>The National Development Plan (NDP)</u>

8.2.1.1.1 Investment in the NDP

The National Development Plan (NDP)[48] sets South Africa's long term vision as to how the economy is to be restructured to create new opportunities. This vision seeks to reduce the inequality and to eliminate the poverty that characterise South Africa. This will be achieved by raising living standards, growing the number of new jobs, improving income and the social wage and the quality of service provision.

Investments are central to the NDP: Growing productive investment is a key aspect of the NDP.

> Fundamentally, the ultimate aim of the NDP besides growing employment prospects is to initiate a number of key changes that can increase investments. The NDP considers that changes are, in turn, required to drive higher rates of investments.

[48] National Planning Commission (undated) *National Development Plan 2030 – Our Future – Make it Work, Executive Summary*.

The changes are numerous but relate to inclusion (including spatially) and to improvements to the education and skills systems.

Changes to the production system are also central to the NDP vision to be reached. As stated in the NDP for the purpose of a faster and more inclusive growth:

> In 2030, the economy should be close to full employment, equip people with the skills they need, ensure that ownership of production is more diverse and able to grow rapidly, and provide the resources to pay for investment in human and physical capital. (p. 28).

The changes that are set in the NDP are laid out from the initial observation of particular problems and imbalances in the South Africa economy that caused low levels of investments. As noted in the NDP, "Investment spending in South Africa fell from an average of almost 30 percent of GDP in the early 1980s to about 16 percent of GDP by the early 2000s" (p. 34).

As should be clear growing productive investments is only one aspect of deeper and more inclusive growth for the country. A complex and virtuous circle of human capital and productive capacity development, the unlocking of infrastructure in such a way so as to offer new integration prospects internationally (e.g. raising exports) are levers required to "increase resources for investment and reduce reliance on capital inflows" (p. 28). In other words, domestic fixed investments for the national and for foreign markets are to be grown.

It starts with better public infrastructure and skills that will allow a more productive base, new sustainable employment prospects with, not only increased living standards but new investments. However, while investments are set in the NDP help expand the production base, enhanced capabilities in the economic area are, in turn, reached through investment.

8.2.1.1.2 Investments that are to be expanded according to the NDP & Expansion Strategies

Lower demand (globally as well as nationally) and changes in the global context means that in the short term, a particular type of investment is to be pursued and which are "in high value-added industries" (p. 21).[49] Again, however, this has to happen in conjunction with improvements in competitiveness and growing mineral exports. Areas in which there are comparative advantages are to be targeted for competitiveness improvements.[50]

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[49] Externally, with growth in the developing countries, new foreign partnerships and export markets are to be unlocked in the NDP. However, given that demand from this markets are with "commodities and raw materials, rather than a more diversified basket of products" (p. 22), a new strategy is required to expand the opportunities around these products.

[50] E.g. in mining, construction, mid-skill manufacturing, agriculture and agro-processing, tourism and business service.

This is an important aspect of the DIPFS. Also of importance is that private investment is to be unlocked in labour-intensive areas. This is one of the many critical actions listed in the NDP. The NDP emphasis the fact that in order to better exploit the opportunities around resources available nationally, investments are needed in R&D. Such investments will also help improve South Africa's international position.

Partnerships are important for the NDP's vision 2030 to be reached.

- Partnerships with foreign partners, including those in the region,[51] will help expand the range of opportunities. On this, the authors of the NDP are cognizant of radical changes in the global economy - specifically, investments in emerging countries – such as in China – will economically alter global dynamics;
- Partnerships with the private sector are important to help "policy certainty" and with "building confidence in the long-term growth of the economy" (p. 29). Moreover, as noted above public-private partnerships are to be pursued to boost infrastructure investments.

8.2.1.2 The New Growth Path (NGP)

8.2.1.2.1 Investment in the NGP

The New Growth Path (NGP) is the programme that defines how the South African economy is to be altered so as to shift the type and rate of growth required to allow for decent work, reduced inequality and the elimination of poverty. Enhancing labour absorption in the economy is a central aspect of the NGP that identifies "areas where employment creation is possible on a large scale as a result of substantial changes in conditions in South Africa and globally." (p. 1).

The NGP, which specifically guides the "policy package to facilitate employment creation" in key areas starts with the recognition that "systemic changes" are required to enhance investments in these areas. Future growth requires significantly higher levels of investment. The NGP also stresses, a "strong social dialogue" and a "comprehensive drive to enhance both social equity and competitiveness" (p. 1).

The NGP specifies a number of job drivers. These are:

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[51] Cross-border infrastructure projects are important for regional integration in the NDP.

- Large levels of public investment in infrastructure with direct and indirect employment creation effects. Indirect effects are garnered through economy-wide efficiency improvements;
- Targeting more labour-absorbing activities in the agricultural and in the mining value chains, manufacturing and services;
- Tapping on new opportunities offered in both, the knowledge and green economies;
- Leveraging social capital in the social economy and the public services;
- Fostering rural development; and, fostering regional integration. Both the aforementioned themes fall under a spatial development heading.

For each of these job drivers the NGP reports core actions with, in a number of cases, the explicit aim of expanding investment.

8.2.1.2.2 Elements supporting investment in the NGP

The NGP sets out that FDI into South Africa is required to help the appreciation of the Rand in the macroeconomic sphere. As expected, the investment context set out in the NGP is similar to that which is set out in the NDP.[52] Similarly, the interventions specified at the high level are, as expected, similar to those set out in the NDP. However, the NGP emphasises a few of the NDP elements more strongly.

- In the international context, the growth in China, India and Brazil and of Africa is noted. Tapping on the new opportunities offered in these markets will help the South African economy.[53] There is a role for agencies that help South African exporters in these markets. Moreover, investment from China, India and Brazil is to be actively pursued.

- Domestically, “effective inducements to private investment in targeted sectors” can be provided by government. These, in the NGP, take the form of “prioritising labour-absorbing activities for the provision of appropriate and cost-effective infrastructure, regulatory interventions that effectively address market and state failures, measures to improve skills systems, and in some cases subsidies to production and innovation.” (p. 7)

- A change that is also set out in the NGP is in terms of the need for BBBEE Codes to be substantially revised. This is not only to help incentivise employment creation.

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[52] A notable inconsistency between the NGP and the NDP is with portfolio inflows that are emphasised in the former but seen as seriously problematic in the latter document.

[53] Relatedly, helping the development of the region will also help South Africa grow to be sustainable.

This is also to help expand "investment in new productive capacity by black entrepreneurs, including small businesses and co-ops (using among others stronger local procurement)" amongst others (p. 22).

8.2.1.3 Industrial Policy Action Plan (IPAP)

Manufacturing has a special place in South Africa's economic growth and job creation efforts: the manufacturing sector is critical because of the linkages (backward and forward) the sector generates. It is a pull growth sector. Developments in manufacturing are important for productivity and structural shifts. Clustering effects that tend to materialize more readily around concentrated manufacturing activities help address spatial unbalances and job creation. Manufacturing exports generate foreign revenues and help reduce risk rating. Manufacturing is more important for the purpose of accumulating capital and to unlock productive investments than other sectors. Economies of scale in manufacturing are important to expand the base of goods to be competitively traded internationally. An expansion of manufacturing is important to help lower prices and to help unlock product quality improvements.

With manufacturing a key economic sector, South Africa's industrial policy is framed by the Industrial Policy Action Plan 2015 (IPAP). This document is guided by the NDP.

Although IPAP seeks to comprehensively reflect the government's approach to industrialization following the adoption of the National Industrial Policy Framework by cabinet in 2007, it is regularly revised to detail key actions and timeframes of interventions by government in the industrial sphere as progress is required and challenges emerge with industry. IPAP 2015 is the seventh version of IPAP.

8.2.1.3.1 Investment and industrialisation in IPAP

According to IPAP 2015, capital outlays in the manufacturing sector contracted by 2% on a year-on-year basis over the first nine months of 2014, compared to a 2.6% contraction in overall private sector fixed investment and a mere 0.3% growth for the economy at large. Factors affecting investment decisions included weak demand conditions, surplus production capacity in numerous sub-sectors of manufacturing, concerns over electricity supply - especially for energy-intensive projects - and high levels of industrial action.

IPAP's 2015 focus is on furthering industrialization in the form of a more diversified production base. Production of non-traditional goods and services is promoted in the latest IPAP, including the following critical programmes:

- Economy-wide pursuit of a stronger articulation of macro- and micro- economic policies;
- Infrastructure-driven industrialisation;
- Resource-driven industrialisation;
- Advanced manufacturing-driven industrialisation;
- Support emerging black industrial entrepreneurs;
- Strengthening the localisation of public procurement;
- Ongoing monitoring and evaluation; whilst strengthening sector strategies and support instruments in key sectors;
- Maximising the opportunities presented to the domestic economy by a growing market on the African continent, and
- Rolling-out the intra-governmental Operation Phakisa Plan for the marine economy.

All of the above critical programmes mention investment as an enabling factor.

Figure 14: Areas of Transversal interventions in IPAP

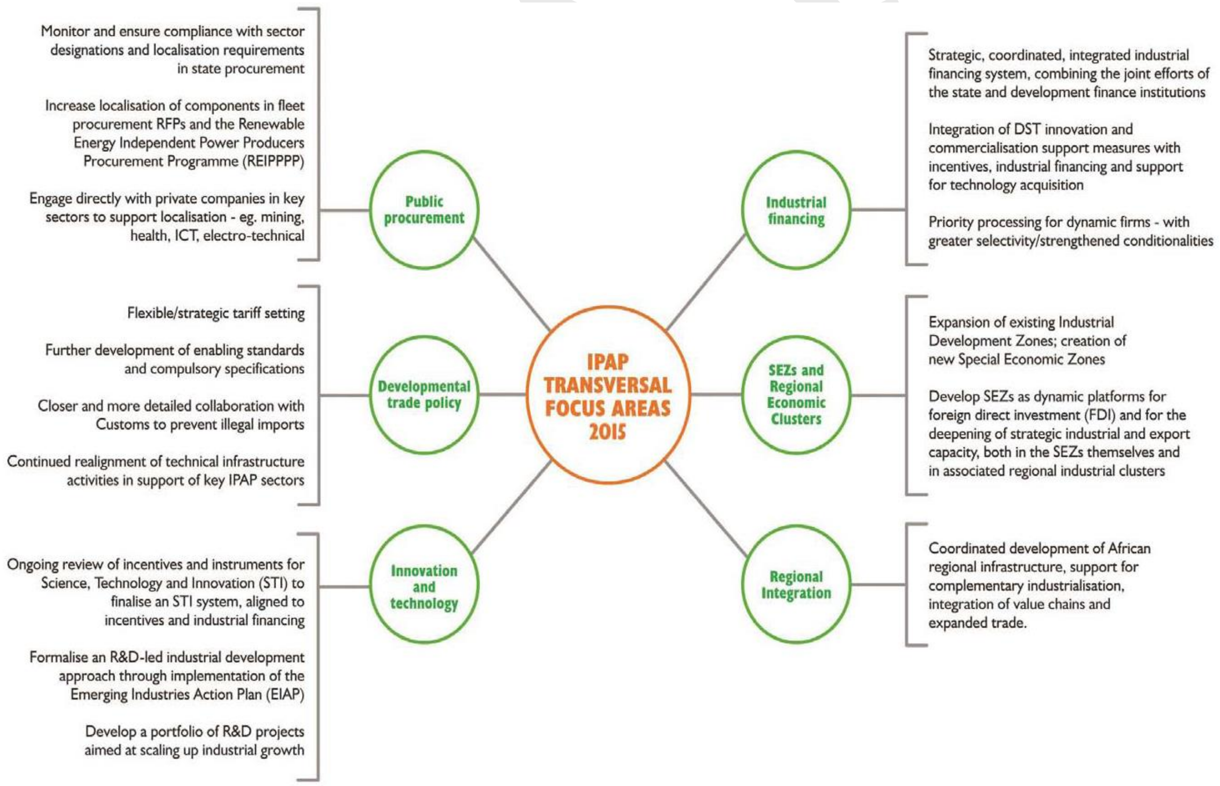


Figure 14 reports the areas of transversal intervention for **the dti**. These, which are complemented by detailed sector-specific support programmes and measures refer to a number of main areas that will directly positively impact on investment. Moreover, IPAP also sees a key role for the state in manufacturing expansion in the area of local procurement.

Box 3: IPAP, Access to Financing & Business Retention

IPAP, though its focus on supporting existing businesses contains core BR&E dimensions. One aspect of IPAP is that it contains industrial financing as one of its transversal area of intervention. Industrial financing has been progressively improved for particular businesses through the Industrial Development Corporation (IDC), a self-financing state owned development finance institution.

Cooperation between **the dti** and the IDC has been with sought to: (i) expand *Low cost finance* in specific projects for specific projects when such finance helps business either expand or survived; (ii) help enhance public and private sector funding as there is an asset-liability mismatch in South Arica which is arising out of insufficient productive fixed investments in the domain of industrial finance. Funding also tends to be channeled in the lower risk or in quick return sectors and projects.

Equity considerations have also altered the traditional IDC offering in order to help black industrialists "acquire *majority* control of manufacturing enterprises, either through new investments or acquisition".

The IDC has a key role to play in this together with the National Empowerment Fund (NEF) going forward.

8.3 South Africa's Relations with Other Countries

The Government utilizes strong government-to-government relations and mechanisms to advance a developmental agenda in Africa and the rest of the world. These agreements focus on:

- identifying and establishing joint investment projects in partner countries;
- promoting two-way trade;
- coordinating South African technical co-operation and assistance to support policy and institutional development in partner countries;
- promoting Cross-border infrastructure development;
- promoting regional integration through the strengthening and consolidation of the Southern African Customs Union (SACU) and the Southern African Development Community (SADC) free trade agreement; and
- negotiating agreements on investment protection and economic co-operation.

- Of greater importance, will be accelerated conclusion of enabling agreements under negotiation, and the implementation measures of those that have been ratified.

A number of Trade and Investment agreements exist between South Africa and other countries. Appendix 1 is the list of Trade and Investment agreements between SA and other countries as well as the objectives of each Agreement.

At the regional level, South Africa, as a member of the South African Development Community (SADC), is looking for particular investment opportunities and a boost to investments through the SADC Investment Protocol (2006). The Protocol defines the role of Investment Promotion Agencies (IPAs) in the SADC region and monitoring and support activities pertaining to foreign investments.

We note in terms of external relations that FDI takes place in a context of ongoing regime changes. These changes have tended to be favourable to investors and, although FDI regimes became markedly liberalised in the mid-2000s, efforts towards investment promotion and facilitation have continued beyond that period[54]. Attention is paid, in FDI regime improvements, to support investments in infrastructure and in services. New restrictions have, however, been put into place for the protection of strategic industries or in industries considered of strategic importance, including transport and energy.

Some of South Africa's FDI partners have put into place new restrictions that should be looked at in the future. The recent shift is revealing of new industrial development concerns in a number of countries as well as symptomatic of the fact that large foreign investing firms have negative impacts on domestic economies. South Africa has also engaged with particular changes as we set out below.

8.4 The National Foreign Investment Context

8.4.1 A relatively Open Regime

South Africa has relatively few restrictions. The OECD places South Africa in a mid-position with regards to restrictiveness of regulations on FDI. Some operational restrictions on foreign-owned firms, together with some equity restrictions are captured as being restrictive.

[54] A number of countries are still in the process of revising their investment models according to UNCTAD (2015).

The fact that South Africa's investment regime is notably open plays a key role in foreign investors' presence of South Africa. Full foreign ownership is allowed and there are comparatively few restrictions applicable to foreign investments and to the holding of national assets by foreigners. Profits and other earnings can be repatriated easily moreover. Complementing the fact that the national investment regime is open is the fact that the South African financial and capital markets are well developed. No performance requirements apply on foreign companies that want to set up or expand. The infrastructure is also well developed when compared to other countries on the African continent. South Africa offers good prospects to foreign investors, particularly with regards to raw materials.

Specifically, South Africa's open regime makes it interesting for foreign investors who seek access to other markets in the region to operate from South Africa (export seeking FDI). The small size of its market South Africa tends to be less interesting to foreign investors that seek to tap on national demand.

While foreign firms are required to abide to all pieces of national legislation, specific incentives are available to foreign investors that bring in new technologies, machineries or equipment. Some sectors have schemes to provide foreign investments with a financial grant (non-taxable) when investments are made in productive assets. Notable on this is the automotive sector with the Medium and Heavy Commercial Vehicles Automotive Investment Scheme. Another recent development that is of interest to foreign investors is with the development of SEZs.

8.4.2 SEZs & IDZs

Special Economic Zones relate to a transformation of a previous scheme, which of the Industrial Development Zones (IDZs) into SEZs with the relevant legislation endorsed in 2013 by the National Assembly and National Council of Provinces Trade and Industry Portfolio Committees.

IDZs are special zones that provide administrative support to foreign firms. Unlike the situation in other countries in the world where special zones have been put into place, IDZs do not provide foreign firms exemptions with regards to labour, environmental and customs requirements arrangements when compared to domestic legislation. SEZs however offer a tax incentive.

Five IDZs are being supported in South Africa but three (Richards Bay, East London and Coega) are fully operational. These IDZs, according to IPAP (2015) have generated R 3.4

billion in investments and 67,000 direct and indirect jobs. Large scale investment have been made in the operation IDZs in South Africa.

SEZs are important to expand the range of industrial capabilities and for domestic investments. A legislation is in place for the regulation and support of SEZs. Firms operating in SEZs have a blanket corporate tax rate of 15% as an investment incentive.

SEZs are turned toward the *manufacturing* of value-added goods. Supplier development programmes and localization are supported with SEZs.

The latest IPAP documents report a number of Action Programmes for SEZs. These are:

- The establishment of Industrial Clusters through the SEZs;
- The planning and development of SEZs, and
- A SEZ capacity building programme in the government agencies and various spheres of government.

Critically a specific outcome of the SEZ programme to expand its manufacturing impact is around the development of additional *industrial* hubs. These are aimed at regionally diversifying the national industrial base. As such, there are three-pronged effects associated with SEZs: increase direct investment, increase exports and develop firm linkages.

The **dti** (2015) is currently working on assessing new SEZs. It notes that serious efforts is required in both, the development and promotion of SEZs and of the development of targeted industrial clusters. SEZ marketing plans will be finalised in 2016.

Regional development is at the forefront of the thinking on regional industrial clusters. To address imbalances in regional development:

> Work is underway to realise this objective by ensuring that regions which have not been designated as SEZs could instead benefit from agglomeration of activities. The interventions envisaged could take the form either of spatial agglomerations and/or active cooperation between firms. (dti, 2015, p. 54)

The approach of SEZ is similar to that set out by Farole (2011) in the World Bank. **The dti** (2015, p. 73) reports particular challenges around SEZs and the development of regional industrial clusters. The following can be used as a checklist of additional interventions by DMs in the development of their industrial hubs in KZN:

- Underdeveloped infrastructure, especially outside the main industrial hubs, including the following:
    - Insufficient energy supply, water shortages and poor road and rail linkages.

    - Absent or extremely weak education and training infrastructure.
    - Port inefficiencies, in particular cargo terminal capacity constraints.
- Unattractiveness of some regions to domestic and foreign professionals.
- Scarcity of existing businesses, especially in low-populated areas

eThe above cut across elements of competitiveness which we have laid out earlier in the document. **The dti** (2015) however adds to the above list: macro-economic instability and access to finance.

8.4.3 Policy Framework for FDI

There is a positive context with regards to FDI in South Africa. In terms of bilateral relations South Africa has shifted its regime with individual countries recently however.

Bilateral FDI arrangements tend to be specified, internationally, through bilateral investment treaties (BITs). International investment agreements and BITs are the main vehicle through which investments are regulated internationally. BITs are important when disputes need to be arbitrated when they arise.

The content of BITs is guided by principles that are negotiated multilaterally; these key principles entail (i) no discrimination across foreign countries from an investment perspective and (ii) no difference of treatment between national firms and foreign firms that are present in the national market through inward FDI. Although particular advantageous concessions may be provided to specific investment partners through BITs on a reciprocal basis, nuances were however for South Africa, until recently, in terms of the different requirements exerted between foreign and domestic firms for empowerment purposes.

Changes on thinking occurred in South Africa with regards to the former arrangements with individual partners. A number of regime changes should be noted as these impact on foreign investors.

Firstly is the fact that South Africa is terminating its international investment agreements. Although a few other countries in the world are following a similar process (e.g. Indonesia), South Africa is seeking through this to alter its international investment agreement strategies. Some BITs have also been terminated with some countries. More (old generation) BITs will be cancelled going forward.[55] The issue on this was for South

[55] This follows a review of bilateral investment treaties initiated by **the dti** in 2007 with findings presented to Cabinet in 2010. Issues are noted around the main body that currently arbitrates investor disputes.

Africa to keep its foreign investment regime open while maintaining the sovereign right and ability of the government to pursue own policy objectives. A more coherent policy framework and a new mechanism to scrutinize complex merger and acquisition (M&A) deals and resulting financial flows were being advocated by National Treasury in the changes.

Another development which has been reported by UNCTAD is in terms of South Africa having recently called, together with two other Latin American countries, for the United Nations Human Rights Council for a new "intergovernmental working group with the mandate to elaborate an international legally binding instrument on Transnational Corporations and Other Business Enterprises with respect to human rights" (p. 107). The relevant resolution was adopted in 2014 but it is not yet clear what is being emphasized by this group.

8.5 Investment Promotion in South Africa

Investment promotion operates at the national, provincial and local level in South Africa. Nationally, Trade and Investment South Africa (TISA) within **the dti** has a co-ordinating and supporting role, not only for investment but also for trade. Investment opportunities identified by TISA are complemented by opportunities that arise from other investment promotion facilitation agencies.

Although it is unclear how much FDI in South Africa is in fact facilitated by TISA, government has used other arrangements to enhanced foreign direct investment, IDZs and, more recently, SEZs as discussed above.

8.6 Performance of the investment context: Competitiveness and Cost of Doing Business

This sub-section briefly presents how South Africa performs on competitiveness from a global perspective as well as on the Cost of Doing Business.

8.6.1 South Africa's Competitiveness

8.6.1.1.1 Global competitiveness

Poor domestic competitiveness matters for FDI. FDI is, in turn, positively influenced by the ease of doing business. South Africa ranks 49th out of 140 countries. Its GCI score is

4.39 compared to 5.76 for Switzerland, the most competitive economy of the World Competitiveness group of economies.

Focusing on South Africa's recent global position reveals some improvements in competitiveness. These have been driven, according to the World Economic Forum, by improvements in innovation and in the uptake of ICTs. South Africa has not markedly improved its general rank since 2007 however.

The country ranks 12th on its financial market. It is faring well on transport infrastructure (rank 29). Issues remain around labour market inefficiencies (rank 107) and education (rank 120).

Detailed analysis reveals that higher education and training are problem areas (86th in 2014). The labor market is affected by extremely rigid hiring and firing practices (143rd in 2014), wage inflexibly (139th in 2014), and continuing significant tensions in labor-employer relations (144th in 2014).

Raising education standards are seen as major areas of change. Labor market reforms are also considered as required by the authors of the *Global Competitiveness 2014-15* Report but South Africa has been good progress on this shifting from rank 113 a year ago to 107.

South Africa is in stage 2 of development, that is it falls in the efficiency driven competitiveness categories of economies, not yet in a transition between this stage and the next one which is that of innovation driven economies.

8.6.2 The cost of doing business

South Africa ranks, in 2015, 73 out of a total of 189 economies. This performance is well above that of sub-Saharan Africa has a whole with a rank of 143. Focusing on the gap between South Africa's performance and the best practice across the entire sample of 36 indicators for all the countries (the frontier score standardised to 100), South Africa's frontier score stood at around 65 compared to around 50 for sub-Sahara Africa. South Africa was below Mauritius and Botswana (rank 32 and 72 respectively) in 2015. However Botswana distance to the frontier score was almost identical to South Africa reflecting a very small gap in performance on indicators of doing business relative to best performance.

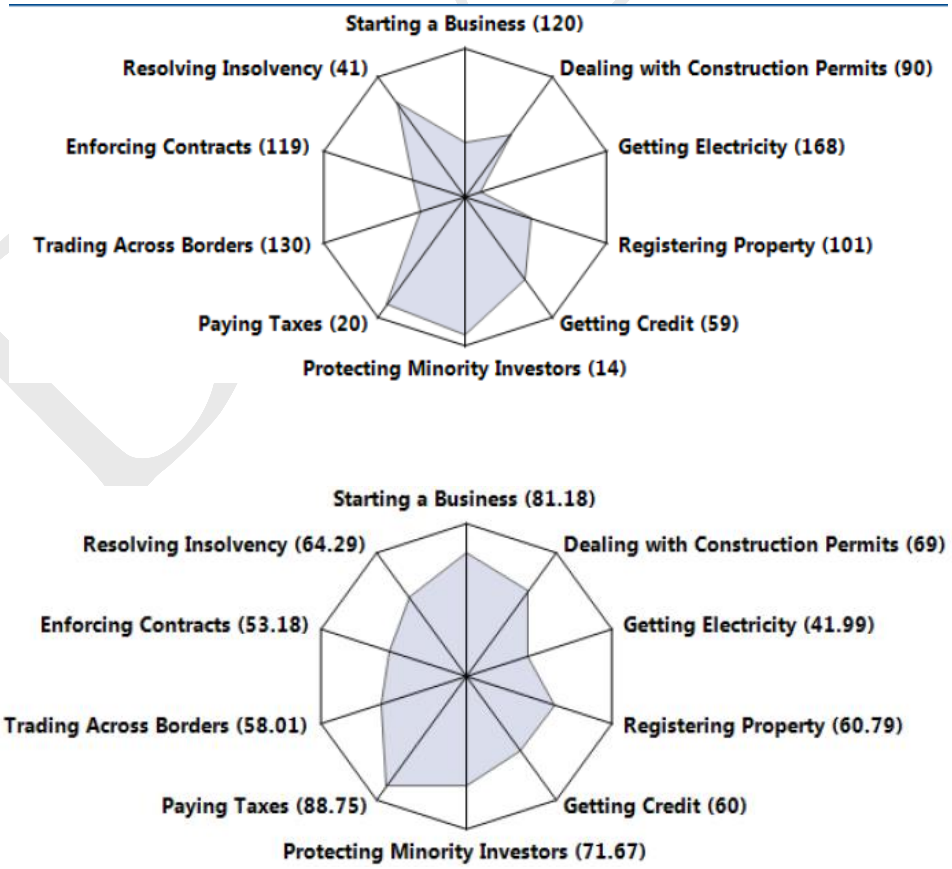
Figure 15 reports how South Arica fares on the main elements that form the cost of doing business. The first part of the figure presents the results in rank terms. The second part of the figure reports performance in terms of the distance to the frontier. With the higher figure representing being closer to the bottom performers, part 1 reveals that South Africa fares particularly poorly on starting a business, on getting electricity and in trading across borders.

The second part of the figure for which higher number reveals a better performance towards the frontier score so that high score is what needs to be sought reveals that South Africa has a poor performance around businesses getting electricity and trading across borders.

The results on starting a business differ because many countries in the world fare poorly on this indicator. This is thus, another important area where South Africa can improve its performance.

Helping businesses to start, helping them get electricity and to trade across borders are three areas where South African policy-makers need to put some notable efforts. However, Figure 15 shows that there are other areas (e.g. help firms get credit) that would help ease business.

Figure 15: Position of South Africa on the main elements that form the cost of doing business



Source: World Bank (2016b, p. 9)[56]

8.7 Implications of South Africa's policies, actions and relations with other countries for a DMIPFS

Key South African policy pieces and action documents place great emphasis on investment and in unlocking fixed private investments significantly in the economy. The emphasis placed on the large impact relates to the need to expand the platform for job creation. A particular type of growth, inclusive growth, that is growth that also helps reduce poverty and inequality in the country however is what is being sought in terms of what is being sought for the country.

Particular areas of intervention are defined along the way with three main areas emphasised as critical for a change of investment and of growth trajectory: infrastructure; education and skills development; and, innovation in the form of R&D to help unlock the potentials which South Africa has in its resource endowments.

In terms of methods, interactions are presented as critical in one key policy document, the document. The document draws on the need to form and partnerships with the private sector. This is set out to expand infrastructure investments, possibly because of the large capital outlays required in that sector.

Partnerships need to also be established with foreign partners and key policy documents refer to miscellaneous BRIC partners as well as to partners on the African continent. IPAP specifically highlights the region as an area for South Africa's expansion in manufacturing (and of outward investment). The pattern of expansion set out by IPAP in this regards is however a joint one, achieved through an integration of value chains.

Particular sectors are being referred to in key policy documents. However, the sectors are looked at from the basis of advancing value addition. This defines new opportunities, including within South Africa where there are regional imbalances. Addressing these imbalances are set out in IPAP, with **the dti** now looking into how to unlock regional industrial clusters as part of its area of transversal, that is cutting across sectors, interventions. Progress has been made on a type of special areas, SEZs, by **the dti** (2015) notes that opportunities around these have not yet been fully developed with SEZs now requiring promotion. SEZs are considered as a tool around which regional industrial clusters are to develop/expand in the relevant regions.

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[56] World Bank (2016b) *Doing Business 2016 Measuring Regulatory Quality & Efficiency – Economy Profile 2016, South Africa*. Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank.

Individual data are available from: http://www.doingbusiness.org/data/exploreeconomies/south-africa which also reports the change in rank between 2015 and 2016.

More broadly, we have also shown that South Africa has a relatively open regime though the dismantling of BITs might have adverse impacts on potential direct foreign investors. While not discussed in this report, there has, in fact, been some controversies around the change and the slow speed at which the new foreign investment framework was being defined and finalised. Yet, South Africa is one of a number of countries that has been looking into an altered foreign investment regime that would help ensure that the activities by the foreign investors are less disruptive and better integrated in a well-defined industrial policy space. Also, research has established that BITs are not a critical determinant of FDI.

It remains that South Africa has good relations with other States. South African policy makers are engaged in pushing the regional integration agenda. Moreover, and positively for foreign investors, the country is benefiting from particular preferences with some large markets. We do not discuss these here but simply point to the renewal of the USA's African Growth and Opportunity Act (AGOA) deal as yielding a notable export advantage in some manufacturing sectors. Benefits also remain with the EU through another (largely reciprocal) trade deal. These deals further contribute to the positive position of South Africa for new foreign and domestic fixed investment.

Further supporting this position is the fact that South Africa has a national IPA that works with other investment promotion and facilitation agencies in the country as well as closely with other IPAs in the SADC region.

Key policy and action documents focus on manufacturing. While particular service sectors increasingly fall under the ambit of industrial policy, this is a sector that tends to be relatively unscrutinised in key policy documents.

8.8 The Provincial Investment Context

8.8.1 Key provincial strategies & policies

We present the main findings of a review that has focused on growing investment in the Province from key policies and strategies that are in support of Investment Promotion and Facilitation Strategies in KZN.

8.8.1.1 The KZN Provincial Growth and Development Strategy (PGDS)

The Provincial Growth and Development Strategy for KwaZulu-Natal[57] (KZN PGDS) sets the strategic framework to accelerate, as well as share economic growth in the province up to 2030. Catalytic and developmental interventions centered around people and the need of those that are the most vulnerable in the Province are set out in the PGDS to ensure that its main strategic objective is met. The overall strategy lays the foundations for attracting and instilling confidence from potential investors and to develop social compacts that address the Provincial challenges.[58]

Investment is one of the central purpose of the KZN PGDS. Specifically, the KZN PGDS' purposes are to:

- Mobilise and synchronise strategic plans and investment priorities in all spheres of government, state owned entities, business, higher education institutions, labour, civil society and all other social partners in order to achieve the desired growth and development goals, objectives and outcomes;
- Spatially contextualise and prioritise interventions so as to achieve greater spatial equity;
- Develop clearly defined institutional arrangements that ensure decisive leadership, robust management, thorough implementation and ongoing review of the growth and development plan.

KZN PGDS recognizes that investments have declined significantly in agriculture and manufacturing in the Province. Reduced investments are noted to be caused by:

- uncoordinated investment and export promotion;
- cost pressure (e.g. electricity);
- Issues in the area of labour; and,
- lack of zoned land for development.[59]

The issues listed above together with other constraints confronting economic actors in the Province will need to be tackled in the province to generate an ex

panded business base. This is a key area for provincial government. But, similarly to

[57] KZN Provincial Planning Commission (2011) *Provincial Growth and Development Strategy* – Building a Better Future Together, August 2011.

[58] The PGDS sets out two main challenges for the Province and these are in terms of improving the quality of education of the poorest while ensure that people are in safe, healthy and that that the communities and livelihoods are sustainable.

[59] Strategic intervention is necessary around zoned industrial land so as "to stimulate investment in areas of high demand and under-supply".

national policy documents, the Province has a key role to play in investing itself as well as in support particular programmes and in developing infrastructure which has been affected by under-investment. Investments are to be made in operational as well as in connectivity infrastructure. Investments in water infrastructure would contribute to new opportunities for agriculture and agro-processing.

While the Province has comparative advantages in transport, logistics and communication, these advantages are not properly exploited and positioning efforts are to be deployed for KwaZulu-Natal to become the "the trade entrance into the continent". Additional investments in the transportation and freight logistics, by providing "an effective platform for forging trade linkages between provinces within the country, with neighbouring states and the rest of the world (particularly the Asian and South American sub-continents)" will "offer the Province considerable investment spin-offs and opportunities." (p. 105)

Although Provincial Government has a key role to play in driving growing investment, it is faced with a stretched budget "for investment in more directly productive programmes". The PGDS sees that there is still room to adopt "innovative funding models and partnerships with private sector" in its financing strategy (p. 68).

The KZN PGDS emphasizes that for this, foreign as well as domestic investments have to happen in "the key productive sectors of manufacturing, tourism, transport and logistics, the green economy and services sectors and assisted through the use of a Provincial Business Retention and Expansion (BR&E) programme" (p. 81). BR&E programmes are critical to help reduce job losses. On this, the PGDS recommends that "an Integrated Provincial BR&E Programme (linked to an Early Warning System and Action Plan for recovery) and including promotion applications for Jobs Fund and Business Distress Fund" be established.

In terms of manufacturing sectors, the PGDS specifies automotive, chemical, metals and maritime explicitly as key sectors. In services, arts and culture are to be positioned as economic sectors.

8.8.1.2 The KZN Provincial Growth and Development Plan (PGDP)

The KZN Provincial Growth and Development Plan (PGDP) is the implementation plan of the PGDS which is the situational overview for the Province with a vision set to 2030. The PGDP specifically identify (i) indicators to measure progress; and (ii) the strategic interventions and catalytic projects for the Province to reach relevant targets.

The KZN PGDP has a number of guiding principles, including that economic growth is a driver of socio-economic change and that "employment equity and other measures of redress should continue and be made more effective by focusing on the environments in which capabilities are developed." (p. 10)

The PGDP framework is that of the PGDS and, as such, trade and investment is one (of many) strategic objective of the strategic goal of job creation. The KZN PGDP sets clear targets for output, employment and GDP (effectively gross value added) per capita.

A number of interventions are proposed to enhance sectoral development through trade and investment in the KZN PGDP and these are:

- To encourage the utilisation and beneficiation of mineral resources and natural gas;
- Enhance value-adding in manufacturing– with a large number of manufacturing sectors specified;
- Develop, diversify and market the tourism sector;
- Improve the efficiency and productivity of the maritime and transport and logistics sectors;
- Facilitate the Expansion of Investment into the Services Sector with investments in Business Processing, Outsourcing & Offshoring, retail and wholesale trade, finance and business, ICT, and the creative industries supported in this regard;
- Establish District Agencies (DAs) to drive local economic development (LED) and investment. These are agencies that remove development constraining obstacles by "coordinating the activities of all key role-players in order to facilitate business expansion and new investment." (p. 34);
- Review the framework to improve access to economic development funding;
- Develop SEZs and industrial hubs.
- Establish an integrated BR&E Programme in line with how it is set out in the PGDS.
- Establish an effective tracking mechanism to monitor provincial trade and investment flows and sector performance
- Enhance Local Procurement and utilisation of local content.

8.8.1.3 KZN Investment Strategy

KZN's Investment Strategy[60] is underpinned by the need for the Province and the Nation to create new jobs. The strategy calls for high levels of investments (private – domestic

[60] Department of Economic Development and Tourism (undated) *KZN Investment Strategy – Promotion and Facilitation Imperatives; Investment Strategy and Implementation Plan*.

and foreign and public in infrastructure and social development) in the productive sphere. The strategy is focused on:

- Enhancing foreign investments (through investment promotion);
- Expanding domestic investment (through investment promotion as well as through BR&E);

For investments to be attracted in the Province, a conducive investment environment has to be put into place. The capacity of all stakeholders - and this includes municipalities, IPAs and DAs - needs to be developed further. This will ultimately allow for the objective of strategy to be reached. The strategy contains a warning and that is that, it "does not actively seek to attract investors located in other provinces" to avoid a "zero-sum game" (p. 4); in other words, "local government will not seek existing investment in other districts, cities or towns: (p. 28). Specifically however,

> The strategy …. emphasizes the importance of a coordinated, integrated, shared system of investment promotion and facilitation that encourages public-private partnerships, and strong inter-governmental relations at all spheres. (pp. 4-5)

The strategy details how investment is to be promoted in the province; which economic sectors to target and where investment is to be located spatially to maximize its socio-economic impact.

Alignment with other policies and strategies is a central element of the strategy. Strategies are with the aforementioned and in terms of dealing with gaps in information gathering and sharing as they relate to investment opportunities.

Following an analysis of the factors that constraints investment and investment growth and the identification that challenges are in fact in 4 main areas (institutional, investment targeting, information, investment environment), strategic thrusts are set out. Each of these contains strategic programmes (in order for the strategic thrusts to be realized).

The strategic thrusts are:

- Achieving Inclusive Institutional coordination;
- Achieve focused investment promotion;
- Promote information & research synergies
- Create an enabling environment
- Tackle skills and resources requirements as a cross-cutting strategic thrust.

The KZN Investment Strategy specifies that investment has to be facilitated where the Province has comparative advantages. However, priority sectors for inward investment into KZN are:

- Manufacturing
- Agriculture
- Agri-processing
- Transport & logistics
- Tourism
- Knowledge, Innovation and& ‘green economy’ sector.

The above sectors can be reviewed for (i) the purpose of alignment and, (ii) to allow for changing priorities.

The strategic sectors to be promoted by the DMs are sectors which have competitive as well as comparative advantages.

Finite resources mean that foreign countries to target for investment are to be prioritized. Three groups of countries are identified in the KZN Investment Strategy but the priority countries for investment promotion and attraction activities are, in the short term, with:

- Brazil, India, Russia and China (as per BRIC & IBSA);
- Japan;
- The UK;
- Germany, Italy, the Netherlands, Spain, Belgium, Switzerland and Sweden in Europe;
- Australia;
- The USA;
- The UAE, Kuwait, Saudi Arabia, Oman, Qatar (the Gulf Co-operation Council countries);
- Thailand, Singapore, Indonesia, Malaysia in South-East Asia.

8.8.2 Investment Agencies in the Province

Investment promotion agencies seek to promote, expand and retain domestic and foreign investment. They also play a key role in expanding exports.

8.8.2.1 <u>The Provincial Investment Agency: TIKZN</u>

A number of provincial public entities have a key role to play in helping growth and development planning. Trade and Investment KZN (TIKZN) is critical for this as they provide a number of strategic interventions required to help address the factors that are associated with reduced and/or insufficient investment.

Basic profile of Trade and Investment KwaZulu-Natal (TIKZN):

TIKZN is a provincial entity of KZN that promotes and facilitates investment opportunities. For this, TIKZN identifies, develops and packages investment opportunities in KwaZulu-Natal; it brands and markets KwaZulu-Natal as an investment destination. It helps retain businesses. TIKZN also facilitates trade by providing assistance to local companies to access international markets. More broadly TIKZN links opportunities to the developmental needs of the KwaZulu-Natal community.

TIKZN assists investors with information; with business permit applications; with the identification and location of suitable premises. TIKZN also assists investors with incentives and with project and operational finance.

The priority sectors evolve but the agency's has some key manufacturing as well as service sectors. TIKZN also helps investment projects in tourism and films though other provincial agencies are involved with this; TIKZN cooperates with Tourism KwaZulu-Natal (TKZN), an entity that reports to EDTEA, as this organization helps position the province of KZN Natal as Africa's leading tourism destination, nationally and internationally.[61]

TIKZN serves all investors and helps target all markets but currently focuses on the countries of the BRIC and countries on the African continent.

According to the KZN Investment Strategy, TIKZN has a key role as a provincial entity in its mandate. The strategy specifies for the provincial investment promotion agency to be involved with the following, amongst others:

- Coordination and building relationships between all institutions, including municipal IPAs and DAs;[62]
- Provide assistance to local government as required (through Memoranda of Understanding with the Municipalities);
- Assess the investment request for key catalytic projects and project manage catalytic investment (as lead project manager or facilitator) and take the lead for cross-cutting and cross municipal boundaries projects;
- Assist project teams.

[61] TKZN's mission is to initiate, facilitate, co-ordinate and implement: strategic tourism marketing; and demand–driven tourism development programmes.

[62] Engagement has to happen through an Investment Promotion and Facilitation (IPF) Forum. TIKZN is to take the lead and thus acts as the secretariat to the IPF Forum.

8.8.2.2 *Municipal Investment Agencies*

According to the KZN Investment Strategy, municipalities have a key role to play in investment promotion as per best practices. Socially, this is important for Millennium Development Goals to be achieved. It is also important for LED as a whole. Moreover, local government functions and their role in the provision of infrastructure and in spatial and development planning all mean that local government plays a key role in influencing the business and investment environment.

For the municipalities to play a key role, national and provincial support, assistance and partnership also have to be in place and investment promotion has to be "prioritized by municipalities". Since assistance is about capacity, the municipalities have to be capacitated. However, the KZN Investment Strategy also seeks to ensure that investment promotion at the municipal level is "further co-ordinated with provincial mandates" (p. 9).

As for local government, it "must commit to reducing red-tape and other bureaucratic bottlenecks between their departments, and between themselves and the other spheres of government on which they rely." (p. 17)

The KZN Investment Strategy specifies investment promotion and facilitation strategies (IPFS) that are district municipality-specific. Specifically, the development of IPFS for each DM is a strategic output of the Strategy. The strategies are to be clearly defined and formulated and must outline "how the districts intends coordinating investment between the local and district functions, and must identify their institution capacity in terms of skills and resources" (p. 40).

8.8.2.2.1 Umhlosinga Development Agency

According to the KZN PGDS, district-level agencies are required to facilitate new investment and expansion of existing business as well as to provide effective business and investor facilitation and support. These are to reduce the regulatory burden, along with a mechanism to act as a brokering agent for large-scale special projects[63].

The Umhlosinga Development Agency (UDMA) is a municipal entity, and registered private company, dedicated to the planning and implementation of a program of sustainable economic growth and development. UMDA was established in 2005 starting its operations in 2008 and over the last 5 years and 4 financial years, has successfully

[63] However, the KZN PGDS document sees the mandating of "appropriate institution or body to act as broker for special projects" as a separate area of intervention later on.

created an environment of serious developmental engagement with both Public and Private sectors. UMDA is allocated in Lot 308, Ebony Crescent in Mtubatuba.[64]

Their aim is to develop uMkhanyakude District's accessibility to local and international markets by harnessing the strategic potential of N2 and new Mkhuze Airport. The agency's focus is on business development and support, agri-business, industry, property development and aviation. (see situational analysis of Umkhanyakude DM for more information on this agency)

8.8.2.2.2 Harry Gwala Development Agency (aka Sisonke Development Agency)

The Harry Gwala Development Agency was created to assist the Harry Gwala DM in promoting the district's local economic development. It is a municipal entity that has a strategic mandate to help promote economic development and create jobs in the Harry Gwala District (Harry Gwala Development Agency, 2015).

The Agency has a management and governance structure. The chief executive officer, Mr. Zolani Cezu, manages the Agency, with the assistance of support staff. The governance includes a council, board of directors and four committees, namely, executive; remuneration and human resource, and finance and internal audit committee.

The Agency's offerings include: investment facilitation; trade promotion; small business support; facilitation of joint ventures, mergers, and acquisitions; broad-based black economic empowerment promotion; land reform support; private sector development; facilitation of environmental impact assessments; town planning for investment support; local economic development; cooperatives development and support; provision of industrial infrastructure, and skills development and training.

The Agency takes a pro-growth approach to promoting rural development focusing on 5 key areas, namely: Sectorial/Industrial Development; Business attraction, Retention, and Extraction; Trade and Investment, and Transformation (pro- poor). The sector focus includes: dairy; beef farming; cash crops; forestry, and tourism.

8.8.3 SEZs and Industrial Hubs in KZN

[64] See: http://www.umda.org.za/

8.8.3.1 Spatial considerations in key provincial documents

Spatial considerations are prominent in key Provincial policy and plan documents. The KZN PGDS notes that KZN's economic activities have remained concentrated in some parts of the Province (in Ethekwini, Msunduzi and Umhlatuze). The KZN PGDS considers that this concentration is influenced by the infrastructure advantages of cities. The document then notes the need to expand the economic infrastructure in the smaller towns "to create other significant contributing economic nodes" (p. 57). The following is to be noted about this strategy of expanding economic development through new economic nodes:

> In seeking to accelerate the pace of delivery of basic services and economic development to all areas of the Province, the principle of densification of human settlements and systematically linking nodal development to economic strategy must be promoted. (p. 66 of the KZN PGDS)

In terms of investment, the document emphasizes that public investment in the province should be directed by the identification of these nodes but involving the private sector:

> Public investment areas are … directed both by the priority intervention areas as well as the identified provincial nodes. It is also envisaged that the nodes would serve as centres where the highest synergies between public and private investment would occur. (p. 148)

A variety of hubs, as a group of activities that complement or support each other and grow through specialisation, are referred to in the KZN PGDS (including the push for an innovation hub) but industrial hubs take central position in the PGDP under the objective of enhancing sectoral development through trade together with SEZs.

For hub development "and/or cluster development", Municipalities have to identify and provide suitably located, affordable serviced land for the purpose of industrial development by the private sector.

8.8.3.2 Industrial Hubs

8.8.3.2.1 District Comparative Advantages

Potential industrial hubs to be developed in each DM have been identified, in KZN, on the basis of a competitive and comparative advantages analysis carried out for each DM.

A report was prepared in 2012[65] that describes the comparative economic advantages in each of the KZN districts and that identifies economic opportunities and catalytic projects

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[65] Department of Economic Development and Tourism/DEDT (2012) *Districts Comparative Advantages Report*. Report prepared by the Economic Planning Policy & Planning Unit, DEDT.

in each district. Elements of competitiveness were also broadly considered. The study relied on published district indicators (desktop) but information was further refined and verified through feedback from planning offices and the private sector represented in chambers of commerce. The large companies that operate in each DM were also identified for the study.

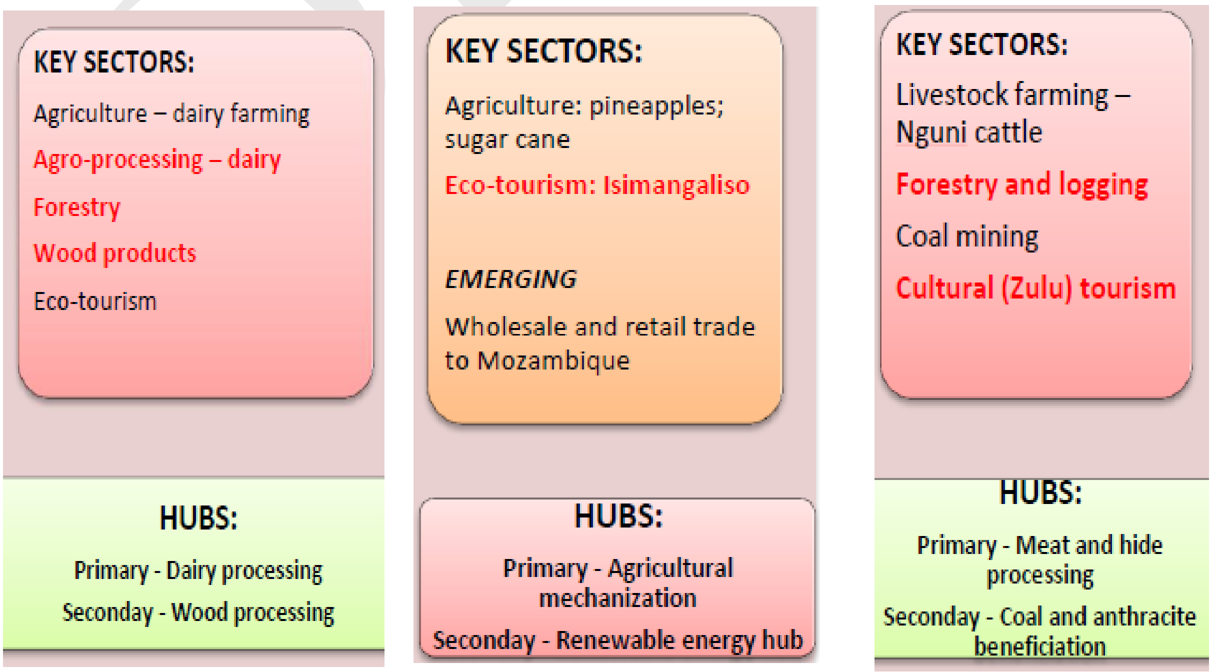
Although locational/access, natural/geographical, infrastructural, resource, human capital, institutional and cultural/heritage advantages were all looked at for each DM, the sectoral comparative advantages part of the analysis specifically involved scrutinizing location quotients. These are simple ratios that indicate where a resource or activity is concentrated in an area relative to what is observed in a larger area.

The District Comparative Advantages study used gross value added data (GVA) for the calculation of location quotients. In turn, to account for changes over time, the analysis was complemented by an examination of GVA growth, labour intensity between 2001 and 2010 as well as and the GVA contribution of sectors in 2010. Emphasis was then placed on where sectoral comparative advantages were high as well as where a District shows sectoral prospects. Particular economic projects are then listed in the report.

8.8.3.2.2 Industrial hubs in the DMs under scrutiny

The key results of the 2012 comparative study for the key sectors, primary and secondary manufacturing hubs (best and second best) are reported for Harry Gwala, Umkhanyakude and Zululand DMs in Figure 16. More background information on these hubs and sectors is available on: www.kznforum.com

Figure 16: Key Sectors and Hubs identified Harry Gwala, Umkhanyakude, Zululand



Source: DEDT (2012, pp. 144-145)

8.8.4 Provincial Policies, Strategies and Actions and the DMIPFS

The KZN PGDS sends a strong message on the centrality of fixed domestic and foreign investment to actively unlock the opportunities so that these are in line with the actual potential of the province. The KZN PGDS reports on specific problem areas in this regard; these are around a poor co-ordination of activities, high labour costs and infrastructure weaknesses.

All types of stakeholders and actors have to be involved in and engaged with the activities required to unlock the economic potential of KZN, but funding constraints are recognised which define a strong role for the private sector, together with the public sector, in enhancing investment further. The KZN PGDS specifically draws attention to the role of BR&E as a tool to help expand private investment. The KZN PGDS defines particular sectors to be unlocked including a number of service sectors.

The KZN PGDS emphasises an African positioning for the investment, but also that connection with other countries is required to alter the current growth trajectory of the province.

The KZN PGDP sets the fundamental role of DAs in enhancing and facilitating sectoral development. It defines the unambiguous role of DMs in terms of them setting out an investment strategy but recognises that the capacity of the stakeholders would have to be developed further in order to boost investment enhancing activities.

The province has an investment strategy as well as a draft export strategy. The investment strategy emphasises a growth of existing and of new investment without diverting investment away from other South African provinces. The investment strategy document sets out particular investment challenges and provides focused and clearly defined strategic thrusts. It also lays out the sectors and countries to prioritise in the short to medium time horizon. The priority sectors are those for which KZN has comparative advantages. These sectors are complemented by those which have resulted from a competitive and comparative analysis that has, recently, been conducted for the DMs.

The export strategy is detailed and provides specific activities to be undertaken by the Municipalities. The strategy sets out particular organisational changes in the municipality in the form of new staff in charge of expanding exports.

The various provincial documents define a new strong role for DMs to play in expanding, both, investment and exports. Capacity issues are regularly noted in these together with the need for some new arrangements and partnerships to emerge involving the DMs and a range of actors at the local level. Positively, the province has a number of DAs and an efficient trade and investment agency as well as a number of other agencies that support the expansion of particular sectors and of investment. The discussion has shown that there are two DAs in the three DMs examined in the projects. They have a distinct focus but their focus is currently well defined.

Key provincial policy and strategy documents and the provincial Growth and Development plan provide detailed information on the challenges to tackle to grow investment, and on the regions/countries and sectors to prioritise. This information has emerge from a number of provincial background studies. The DMs should take note of the fact that there is clear information and clear guidelines in the main current documents to help define the starting focus of their DMIPFS. This will help facilitate the process of selecting which information to provide to potential investors, which potential investor to actively pursue and where challenges are to be addressed locally. Which industrial hubs to develop have already been well laid out for each DM but these require adequately serviced land to be available to private investors to be fully effective.

9 PRESENTATION OF KEY INVESTMENT PATTERNS & TRENDS

This section presents an analysis of the foreign and domestic investment trends and patterns for South Africa. We then turn attention to presenting the pattern of investment for KZN and for the DMs of Harry Gwala, of Umkhanyakude, and of Zululand but note that only some FDI projects are available for KZN as a whole and not for the DMs. Data for DMs are with TIZKN but might only represent a portion of all foreign investment projects in the DMs since TIKZN only has data for actual and potential projects for which it is involved.

9.2 Foreign and domestic Investments in in South Africa

9.2.1 Foreign Direct Investment

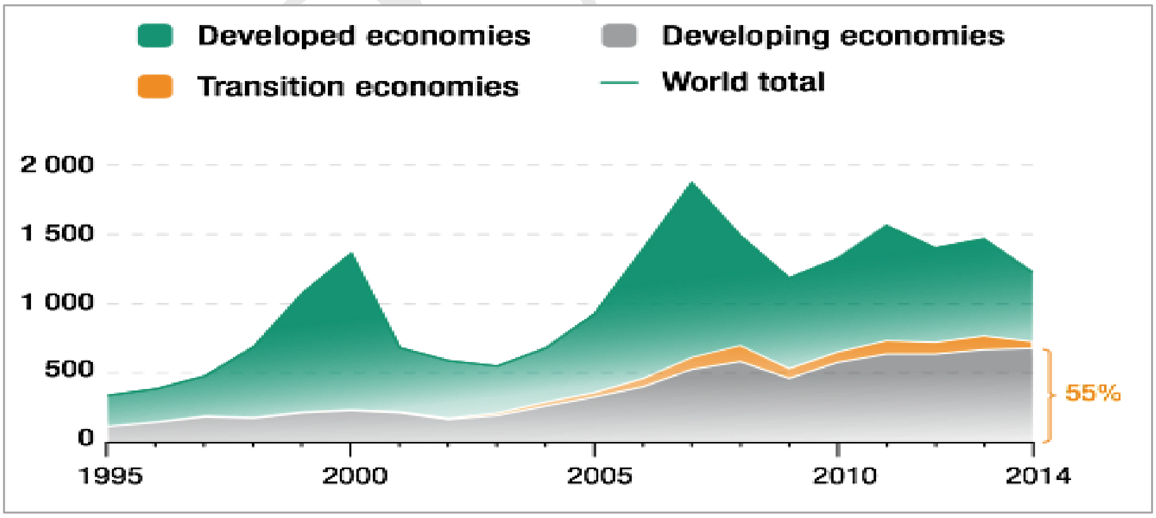
9.2.1.1 *Recent International FDI Trends*

9.2.1.1.1 Overview of Flow changes

As indicated in the discussion of the determinants of investment, FDI flows tend to be influenced by the economic conditions and risks that prevail globally. Such flows are also indicative of the growth conditions in particular regions of the world and of economies within these. FDI outflows reflect large firms expanding outside their markets while FDI inflows indicate prospects for an expansion and development in a host economy.

Figure 17 below, illustrates the FDI inflows for the world and for various types of economies over the last two decades using data from UNCTAD[66]. It shows a general upward trend of such flows. Fluctuations however characterise FDI inflows in the period under consideration: following an overall notable growth in world FDI inflows between 1995 until 2000, a decline occurred between 2000 and 2003. FDI then experienced another cycle of growth between 2003 and 2007; in that period FDI inflows increased markedly. Figure 17 also illustrates that FDI inflows declined between 2007 and 2009 with direct foreign investors pre-empting the crisis. Some recovery took place in FDI inflows between 2009 and 2011 followed by another episode of decline in global FDI flows between 2011 and 2014. At the end of 2014 world FDI inflows stood at US$1.23 trillion but these flows had not, then, recovered to their 2007 levels.

Figure 17: FDI Inflows global and by type of economies, 1995 – 2014 (US$ Billions)



Source: UNCTAD (2015, p. 2).

Figure 17 also reveals some key changes in terms of the type of economies that receives FDI. The data identify the emergence of the transition economies from 2005 onward as

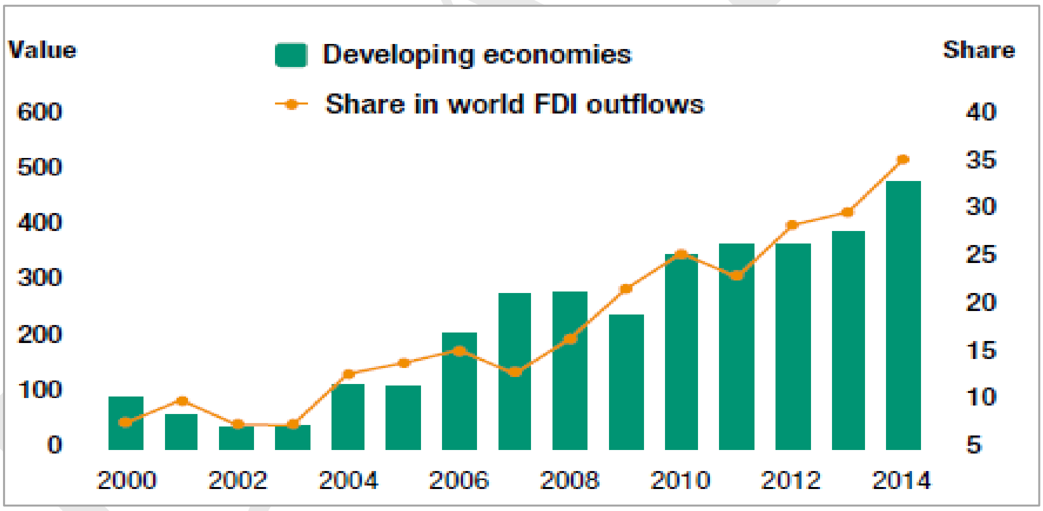
[66] UNCTAD (2015) *World Investment Report – Reforming International Investment Governance*. Geneva: The United Nations Conference on Trade and Development.

important FDI host economies. But, it is what is happening with the developing economies that is notable.

Developing countries have markedly grown in importance as FDI recipients from the mid-2000s onward. Recent data reveal that more than half of global FDI flows are now destined to the developing economies, particularly to developing Asia. Nevertheless, while not illustrated in Figure 17, FDI flows to Africa have increased and have, in fact, recently remained relatively stable, standing at US$54 million. In contrast with what is going on in the transition and developing countries, the FDI inflows of developed countries have declined relatively, particularly since the global crisis.

In parallel to what is happening to inflows, FDI outflows from the developing countries have increased markedly in the second half of the 2000s (see Figure 18). By 2014, FDI outflows from the developing countries amounted to 35% of world FDI outflows. According to the recent *World Investment Report*, outflows by the developed countries have been relatively stable, standing at around US$820 million.

Figure 18: Importance of developing countries in FDI outflows. Values and share of outflows (in US$ Billions & % respectively)



Source: UNCTAD (2015, p. 6).

The above has identified some marked shifts in terms of FDI flows over time. As noted above, inflows matter because they influence the stock of FDI that is in regions or countries. Outflows tend to indicate which home economy is growing and when outflows accelerate, this is a general sign of globalisation or expansion into new markets by firms. It is notable, as such, from the data that changes have been with the developing countries as both recipients and initiators of FDI flows.

9.2.1.1.2 Main FDI sectors

Sectoral changes are also apparent in FDI flow data with shifts taking place towards services. Noting that FDI data for services have slowly improved over time, there has been a long but persistent pattern of shift of FDI to that sector. In 2012, services held a 63% share of global FDI stock; 26% was then in manufacturing and 7% in the primary sector; the residual, that is 4% of the sectoral composition of the global FDI stock, is unspecified.

International data reveal that growth in FDI in services has happened in parallel to a reduction of the share of manufacturing in global FDI. As reported by UNCTAD (2015, p. 12): "Overall, since 1990, the share of services in world FDI stock has gained 14 percentage points (from 49% to 63%) with a corresponding decrease in manufacturing (from 41% to 26%), while the share of the primary sector has been stable (at about 7%)". This shift is the result of the growing trade orientation of services and fact that the growth of global value chains is being supported by services.

As should be clear, services is the sector that has experienced the most notable growth for FDI over time. Recent announced greenfield project data also identify that such projects are prevalent in the services sector generally but particularly for the developing countries.

9.2.1.1.3 Recent Developments in FDI: The Continued Rise of the Developing Countries

Weaknesses in the global system have been causing some declines in FDI since 2011.[67] Multinational companies are engaging with large cross-border deals, but also drive divestments. This is what has happened recently with divestments at times offsetting new investments.

Although divestments have been taking place in 2013-2014, very high FDI flows were observed for the developing countries with foreign investments flows to China at notably high levels. More broadly, the fact that five developing countries feature in the top 10 FDI recipients in the world suggest that new dynamics are at play that lie with particular economies. While we have illustrated this above, the developing countries are important generator of FDI themselves, particularly for new, that is greenfield investments. New investors are emerging with multinational enterprises (MNEs) from Asia and the transition economies leading the way.

Key elements with Asian MNEs are in terms of a growth of FDI to such an extent that they are now the world largest investing group, accounting for almost one third of the world

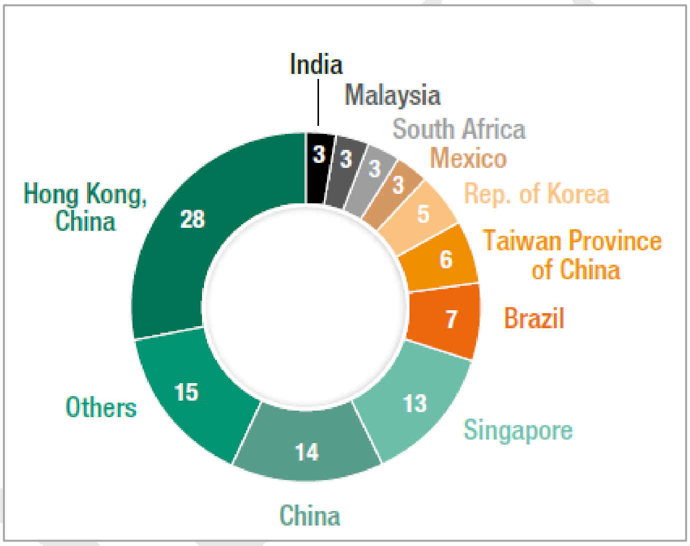
[67] They have also caused changes in FDI types; FDI then changed in favour of cross border M&As reflecting more risk.

total FDI outflows (UNCTAD, 2015, p. 5). Notably, China is now displaying a growth of FDI outflows that is above the growth of FDI inflows. Some other economies, such as the Russian Federation amongst the transition economies, have remained large investing nations. Indian MNEs are now back to expanding outward after a short period of contraction.

Generally developing countries have continued to be a growing source of FDI to other developing countries.

Figure 19 lists the main developing countries that have engaged with FDI in other developing countries and their contribution, in percentages, in the total of FDI stock from the developing countries to other developing countries.

Figure 19: Percentage of FDI Stock destined to Developing Countries from Developing Countries (Countries and their contribution to total in %)



Source: UNCTAD (2015, p. 10)

9.2.1.1.4 FDI from the Developing Countries on the African Continent

Both China and India are important to the African continent in terms of FDI but new non-developing partners are emerging that are initiating investments in Africa: the UAE accounted for 6 per cent of total capital expenditure related to greenfield FDI projects into Africa in 2014, targeting consumer industries, infrastructure and services (UNCTAD, 2015, p. 34).

9.2.1.1.5 South African Multinational Enterprises (MNEs)

Almost one forth of FDI onto the African continent is destined to the Southern African region. In fact, South Africa is an important investing partner, not only in the region but also on the African continent. South Africa presence in Africa in FDI terms was in 2013, more important than that of China.

Figure 19 above shows that, generally, South Africa is a major FDI source for other developing countries[68]. More broadly and strikingly, South Africa grew its presence abroad in 2014.

Table 4 below which reports the relative importance of the host economy in the outward stock of the investor country compared to the importance of the host economy in global FDI (the FDI intensity) reveals that South Africa is important for the development of neighbouring economies; it is also a major home economy for FDI beyond the Southern Africa zone.

FDI outflows from South Africa amounted to nearly US$7 billion in 2014. Some key projects drove this figure and its top ranking as the main home country on the African continent.[69]

Table 4: FDI Intensity into selected host economies by South Africa as a home country, 2012

Swaziland	101.0
Zimbabwe	71.6
Botswana	64.7
Namibia	64.0
Malawi	49.2
Mozambique	32.0
Lesotho	27.8
Ghana	24.1
Kenya	22.1
Luxembourg	16.0

Source: UNCTAD (2015, p. 9)

In terms of sectors for the South African MNEs, as FDI in Africa by other African partners have expanded intra-Africa greenfield investments (with projects in retail banking and in insurance), the strong presence of South African firms in Africa in finance is emerging sharply.[70]

[68] South Africa is the largest investor in Africa with over US$20 billion of FDI on the continent.

[69] E.g. the large real estate greenfield investment by Atterbury Property Developments in Mozambique amounting to US$2.6 billion in 2014. Some divestments however occurred from South African firms, notably the divestment of Usutu Forests Products Co Ltd in Swaziland to local investors in Swaziland by Sappi Ltd.

[70] There are other large investors in Africa but South African MNEs are in different sectors (telecommunications, mining and retail).

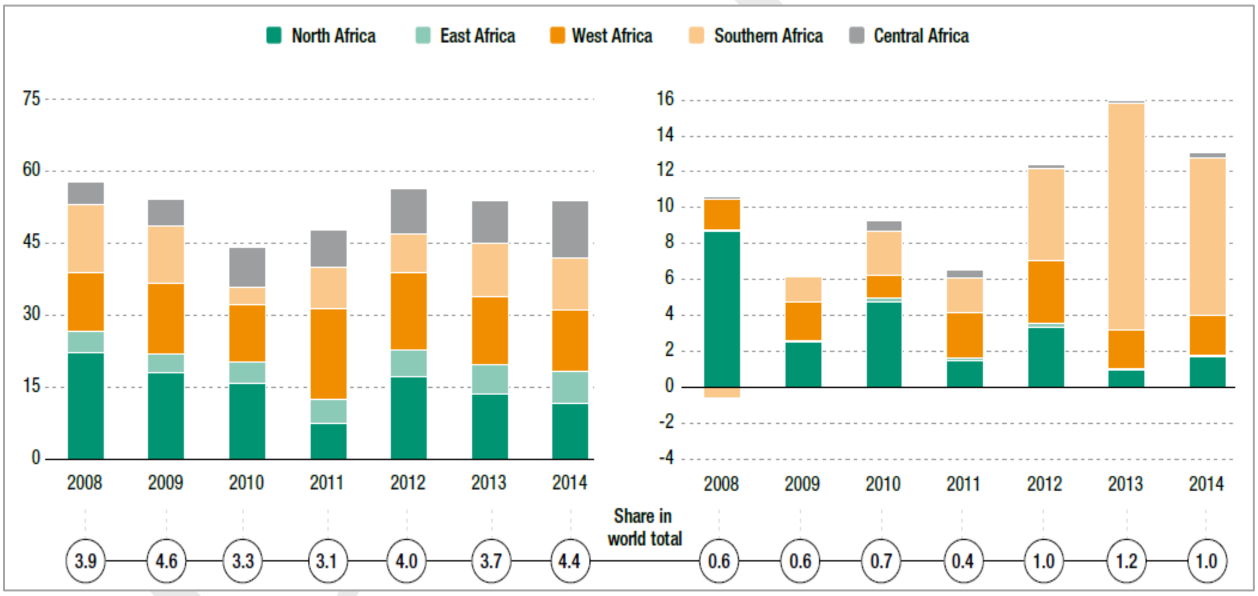
9.2.1.2 FDI trends in South Africa

9.2.1.2.1 FDI into South Africa

There have been fluctuations in FDI inflows and in FDI outflows with and from the Southern Africa region (which includes South Africa) in the recent past. Yet, as can be seen in Figure 20 outflows have tended to grow even though such flows are small compared to the value of flows in other parts of the world. The lower part of Figure 20 (where the share in world total is reported in circles) shows that Africa absorbs around 3%-4% of all world FDI inflows. This is a small share.

FDI outflows from the Southern African region are, as expected, smaller in value terms than flows into the Southern African region. FDI inflows in South Africa recovered somewhat after the crisis but dropped recently.[71] FDI flows to South have Africa also declined.

Figure 20: FDI Inflows (left graph) **& outflows** (right graph) **for Africa, 2008-2014 (US$ Billions)**

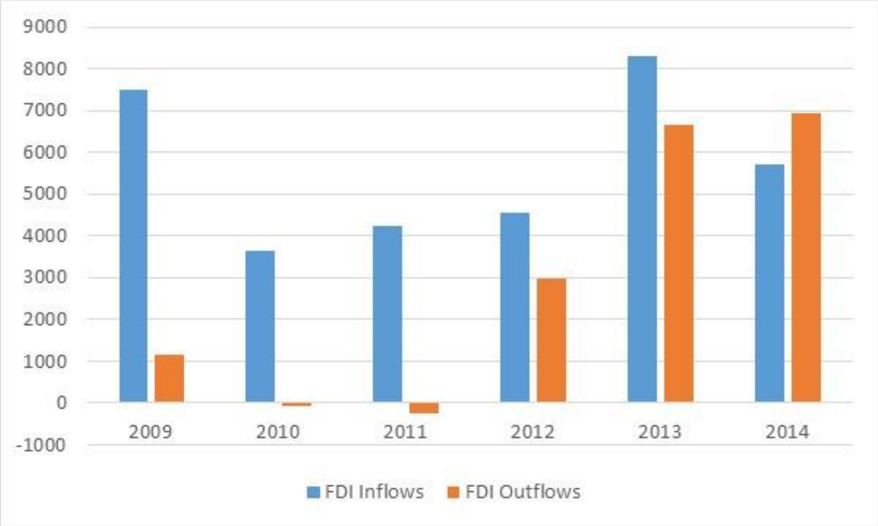


Source: UNCTAD (2005, p. 33)

Figure 21 reports the values of the FDI flows out of and into South Africa for the 2009-2014 period. The figure shows high/growing value of outflows from 2012 onward after divestments in 2010 and 2011. Generally FDI inflows have been in excess of FDI outflows – except in 2014.

71 Fluctuations in FDI inflows in Figure 20 reflect developments in flows to particular countries in the Southern Africa region. Thus, recent declines in FDI flows to Mozambique influence the overall picture for the region.

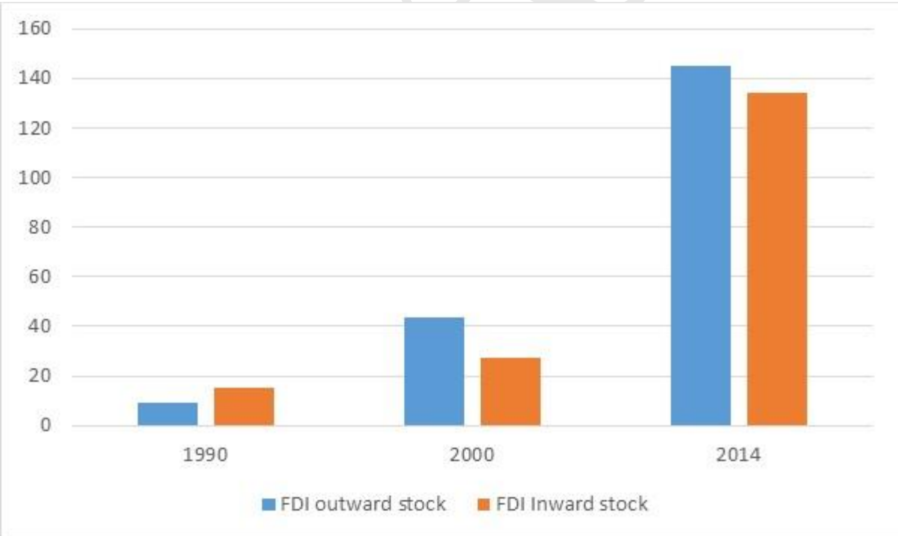
Figure 21: South Africa, FDI inflows and outflows, 2009-2014 (US$ Millions)



Source: UNCTAD (2015, p. A4).

Figure 22 below, reports on South Africa's FDI stock for some selected years (1990, 2000 and 2014). The data illustrates a growth of both the inward and outward stock with the outward FDI stock in excess of the inward FDI stock in 2000 and in 2014.

Figure 22: South Africa's FDI stock for selected years (US$ Billions)



Source: UNCTAD (2015, p. A8).

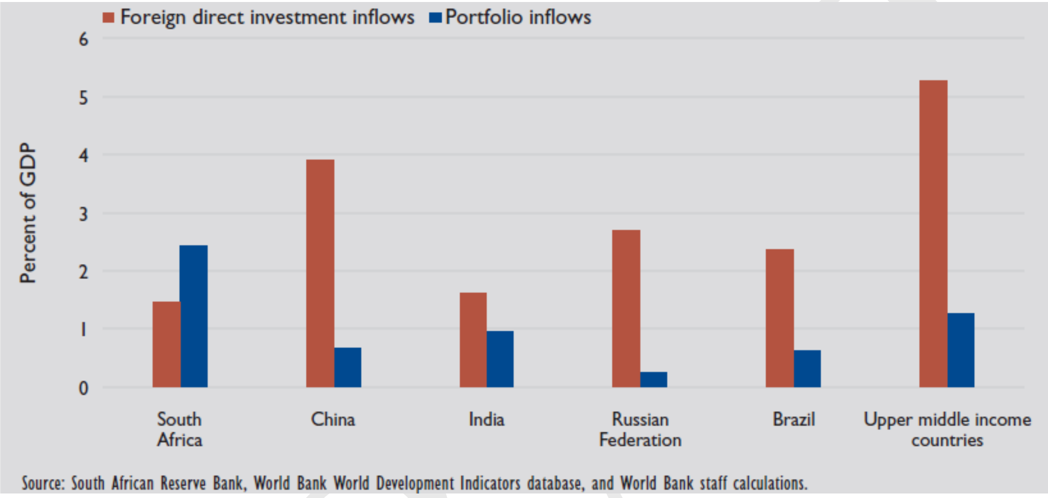
9.2.1.2.2 Growth of FDI investment but poor performance when compared to other countries

Growing FDI stock is good news for South Africa.[72] FDI inflows have been mediocre compared to other countries however. While FDI investment has tended to average 1.5 %

[72] Growth in stock link to a growth of flows. This is a positive development for South Africa as the large current account requires foreign investment, particularly of the FDI type to help grow the economy.

of GDP in South Africa in the 2000s, the similar figure for upper middle income countries was of at more than 5% of GDP (see Figure 23). Numerous reasons are put forward for this comparatively low performance in FDI by South Africa. These are listed in Box 4 though competitiveness problems and deficiencies around particular elements of Doing Business presented in Section 8.6 also matter in this regards.

Figure 23: Capital flow, including FDI as % of GDP, comparison between 2002-08 average of South Africa with BRIC and upper-middle income countries



Source: World Bank (2011, p. 12)[73]

Box 4: Possible reasons what South Africa is attracting less FDI than is possible

South Africa is consistently underperforming in attracting FDI. This remains a puzzle researchers and development agencies alike. While FDI surveys are rare in South Africa, researchers have drawn that the following reasons for the underperformance of South

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[73] World Bank (2011) "South Africa - Economic Update, Focus on Savings, Investment and Inclusive Growth", July 2011, Issue 1. Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank, Africa Region.

Note that the Wold Bank on its World Development Indicator website provides FDI as a % of GDP data for South Africa as well as for a large range of other countries.

Africa:

- the small size of the South African and Southern African market (at least in income levels and spending terms). This is compounded by a relatively mediocre growth performance of these markets as well as uncertainty and political volatility in some countries in the region (e.g. Zimbabwe) and in some parts of South Africa (e.g. service delivery riots). The latter has particularly dampening effect on greenfield investment;

- Negative perceptions of South Africa and of the African Continent more broadly (e.g. through the news). A number of studies refer to crime in South Africa as a particular and distinct problem area. However, what type of crime impacts on business is hard to establish. Crime has been found to be correlated to firm exit in the form of closure in recent research in South Africa.

- Insufficient skilled workers which is manifest in a very high wage premium secured by those with high levels of education.

- The cost of interest is at times reported to be high for foreign investors. However, these tend to have access to capital on other markets which provide lower interest rates. Also capital fares well in terms of interest spread and margins, even compared to some regions in Asia.

- Currency volatility; this bias FDI away from greenfield projects where risks are higher and towards services which are less reliant on fixed capital.

- Costly and difficult firing procedures are frequently reported as a problem area.

- Administrative burden which divert resources from productive activities.

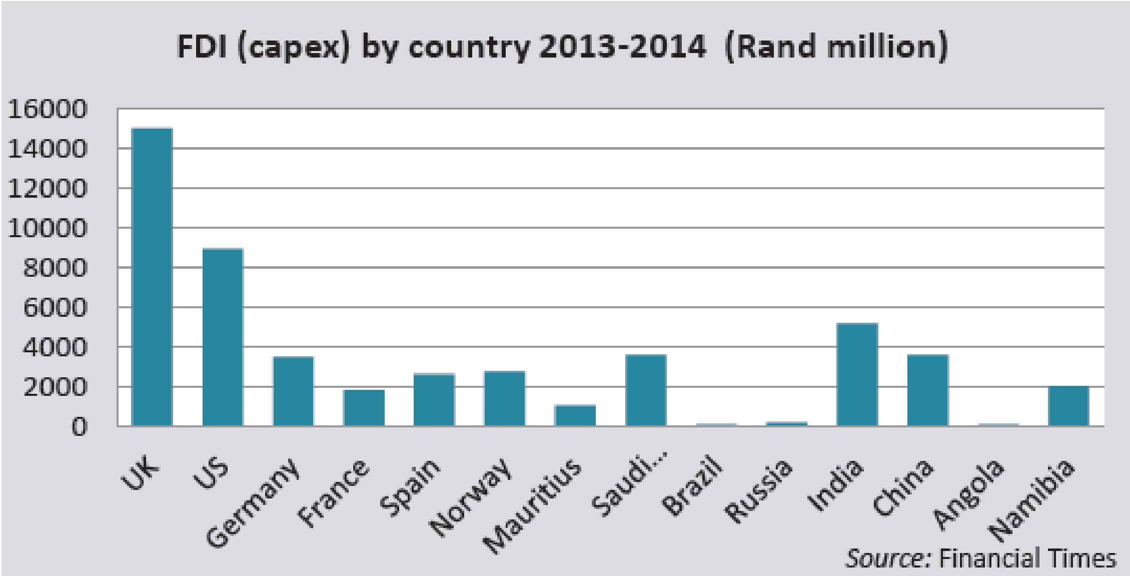
- Uncertainty associated with new policies (e.g. on BEE policies in the past);

- Although low investment returns are frequently reported, research suggests that this is not actually the case however.

9.2.1.2.3 Origin of FDI

We have noted above the rise of developing countries as investors in other developing countries, including China. While this trend should be noted, FDI into South Africa remains dominated by a number of developed countries. Which developed country dominates vary across the years but, the USA dominated in 2013-14 amongst the list of countries which have FDI in South Africa as can be observed in Figure 24. A number of EU countries, notably the UK tend to consistently appear as in the list of countries that have FDI in South Africa

Figure 24: FDI into South Africa for Selected Economies in 2013-2014 (R millions)[74]



Source: ***The dti*** *(2015, p. 25)*[75]

9.2.1.2.4 FDI Sectors

As noted above, FDI in the services sector have grown while that of manufacturing has declined relatively. Generally FDI into South Africa is dominated by services as shown in Table 5. South Africa is a base from which foreign firms look to expand elsewhere, including in services. This export orientation is apparent in some of the large foreign IT/call centre firms that set up in 2013/2014 in the country. The *World Investment Report 2015* also refers to the completion of the Marriott's acquisition of the Protea Hotel Group as another example of South Africa being used as a base from foreign firms to operate in the region.

Table 5: Sectoral Composition of FDI, 2015 (%)

Agriculture, forestry, hunting & fishing	0.1
Mining & Quarrying	23.5
Manuf	16.5
Elec, gas & water	0.1
Construction	0.2
Trade	4.9
Transport, storage & communication	10.3
Finance, real estate & Business Services	44.4
Community, social & personal services	0.1
TOTAL	**100.0**

[74] UNCTAD does not indicate the sources of FDI flows to South Africa. Original data are available from the SARB for each main regions of the world and countries within these regions however.

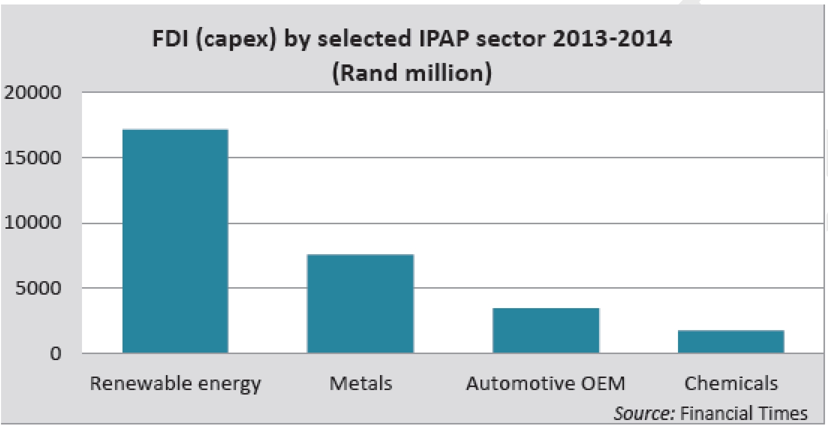
[75] The **dti** (2015) *Industrial Action Plan 2015*, Economic Sectors, Employment & Infrastructure Development Cluster Ipap 2015/16 – 2017/18.

Source: Own Calculations using data from the SARB

FDI has progressively increased in finance and in transport, storage and communication.

WIR 2015 refer to loans and equity injections provided to South African subsidiaries of foreign corporations in various sectors, ranging from leisure and telecommunications, through automotive manufacturing and renewable energy. Figure 25 below confirms that, within manufacturing, FDI has recently been locating in renewable energy. FDI into South Africa has generally been recently towards electricity- and capital-intensive sectors.

Figure 25: FDI into South Africa by Selected IPAP Sectors in 2013-2014 (R millions)



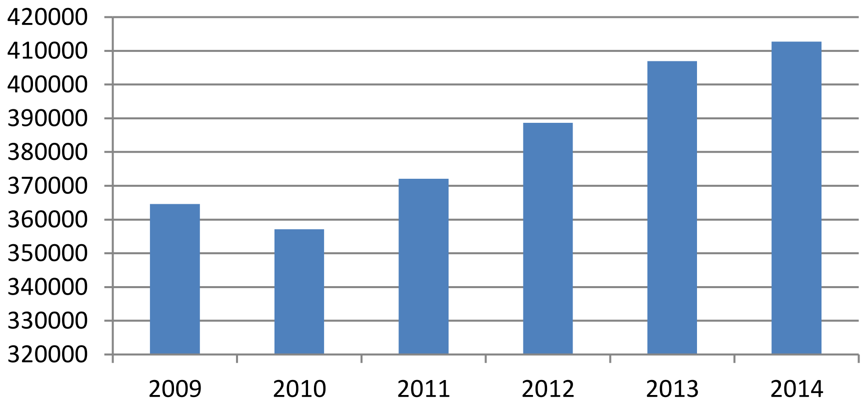
*Source: The **dti** (2015, p. 25)*

9.2.2 Domestic Investments

9.2.2.1 <u>Low domestic fixed investments</u>

Figure 26 below presents gross domestic fixed investment (GDFI) in South Africa between 2009 and 2014. The figure indicates some recovery after the crisis. In 2014, GDFI stood at around R413 billion.

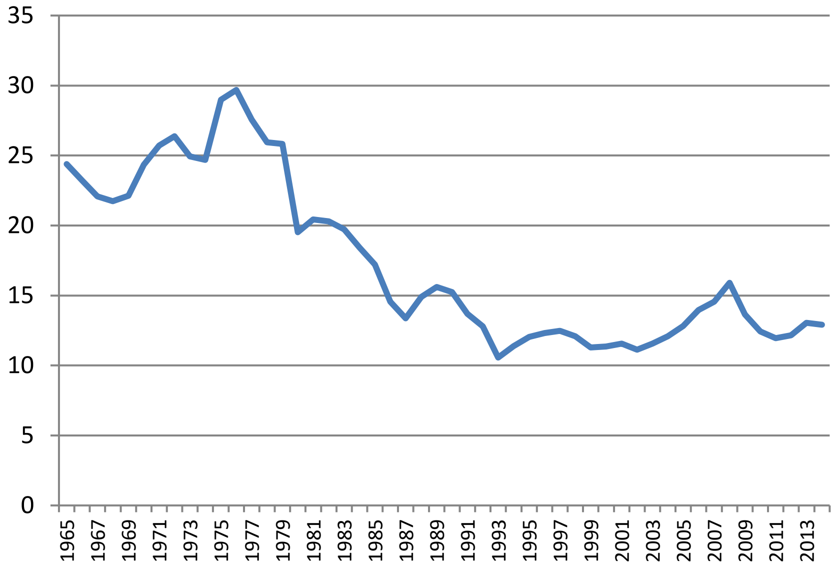
Figure 26: Gross domestic fixed investment in South Africa (Rm constant 2005 prices) (R millions at 2005 constant prices)



Source: Quantec database

Of concern is that domestic investments are low in South Africa, particularly when data are looked at over a long time horizon. Figure 27 shows this through a presentation of GFCF as a percentage of GDP since 1965; the figure shows the relative collapse of domestic private investments after the 2008 economic crisis followed by slow subsequent improvements.

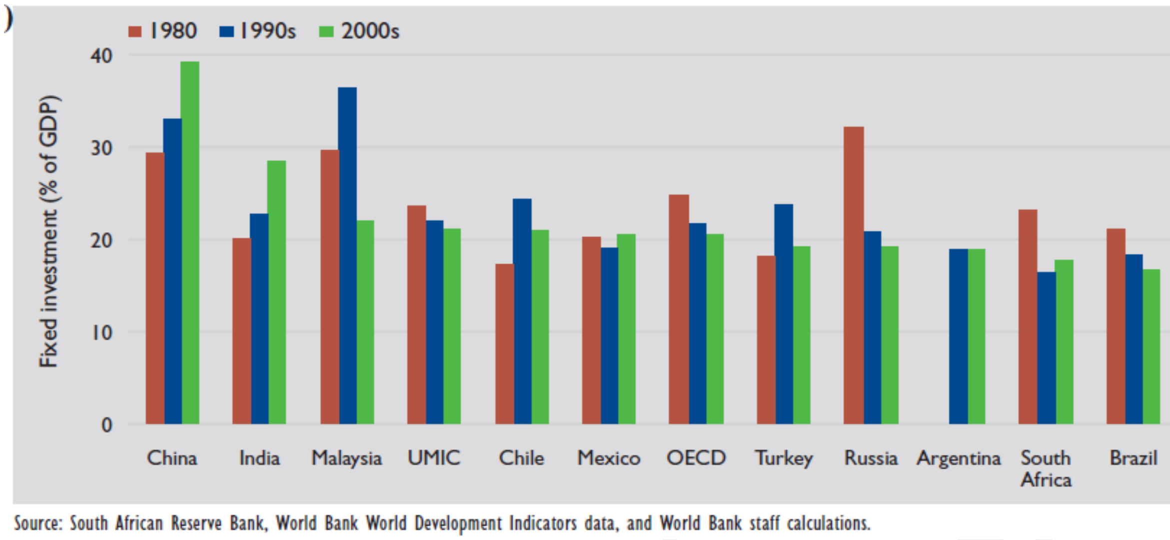
Figure 27: Gross fixed capital formation by the private sector in South Africa as % of GDP, 1965 to 2014



Source: World Bank, World Development Indicators

Figure 28 shows that South Africa has been performing relative poorly over the 2000s but not as badly as Brazil. Generally South Africa is underperforming when compared to a number of countries.

Figure 28: Domestic investment as % of GDP in South Africa compared to other emerging economies (1980, 1990s and 2000s)



Source: World Bank (2011, p. 18)

9.2.2.2 <u>Explaining low fixed domestic investments</u>

The identification of the causes of low fixed domestic investments in South Africa remains a source of investigation. At the core of the investigation is the fact that low fixed private domestic investment, combined with low FDI levels into South Africa, threaten prospects for future economic growth.

Although some research has identified issues specific to South Africa in the poor FDI performance (e.g. crime), returns to capital have been found to be high. It can thus be eliminated as a potential explanation for low private investment rates. Research has, therefore, turned to an examination of saving as another possible root cause of the problem though other structural impediments and poor perceptions related to risks in the country are also raised as problem areas.

9.2.2.2.1 Low savings

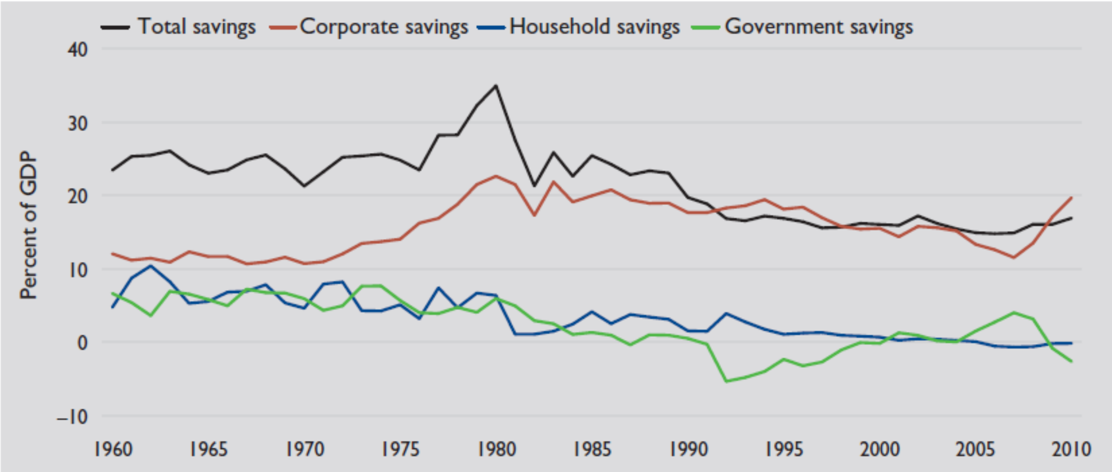
National saving rate (as a share of GDP) is strongly and positively correlated with investment saving rate (as a share of GDP).

UNCTAD reports generally issues with low domestic saving in Africa, including South Africa. It notes that low saving relative to needed investment is affected by the large scale of informal activities on the African continent. Noting that South Africa has a small informal sector relative to what is observed for similar countries elsewhere, savings are low for other reasons.

Saving by households has declined over time and is low, having dropped to less than 1%

of disposable income between 2000 and 2001 and remaining below that level since. Corporate savings have also progressively declined but appear to be increasing again since 2007/2008. However, when all types of savings are combined, South Africa has generally experienced declining and low saving rates over a long time horizon as can be seen from Figure 29 below.

Figure 29: Gross Corporate saving in South Africa (as % of GDP, 1960-2010)



Source: World Bank (2011, p. 20)

9.2.2.2.2 Other factors

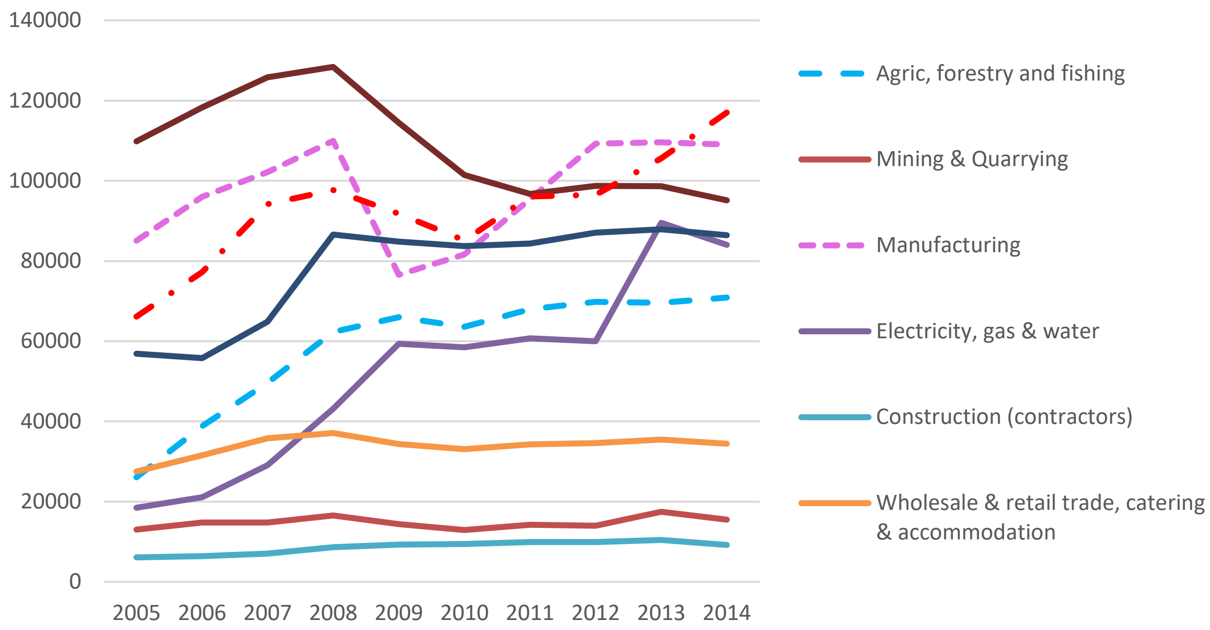
Other factors are raised as adversely affecting fixed domestic investment in South Africa. While skill weaknesses are frequently mentioned, labour market problems and labour relations appear as constraints in a context in which labour productivity is only slowly improving. Strong labour market inefficiencies are identified in the evaluation of South Africa's competitiveness (see Section 8.6 above)

9.2.2.3 *<u>Fixed investments by sector</u>*

Figure 30 reports how GFCF at 2010 constant prices has evolved, by sector, over the last 10 years in South Africa. The figure illustrates that all economic sectors, except construction, were affected by the 2008 crisis. Nonetheless GFCF has tended to grow in all sectors with the exception of mining & quarrying.

According to SARB GFCF data, 19% of GFCF would be with community, social & personal services, 17.5% with manufacturing, 15.3% with financial intermediation, insurance, real estate & business services, about 14% with Transport, storage & communications, 13.5% with Electricity, gas & water, and 11.4% with agriculture, forestry and fishing; the remaining 9.5% would be with other sectors reported on Figure 30 not already listed.

Figure 30: Gross fixed capital formation by sector in South Africa, 2005-2014 (R millions at 2010 Constant prices)



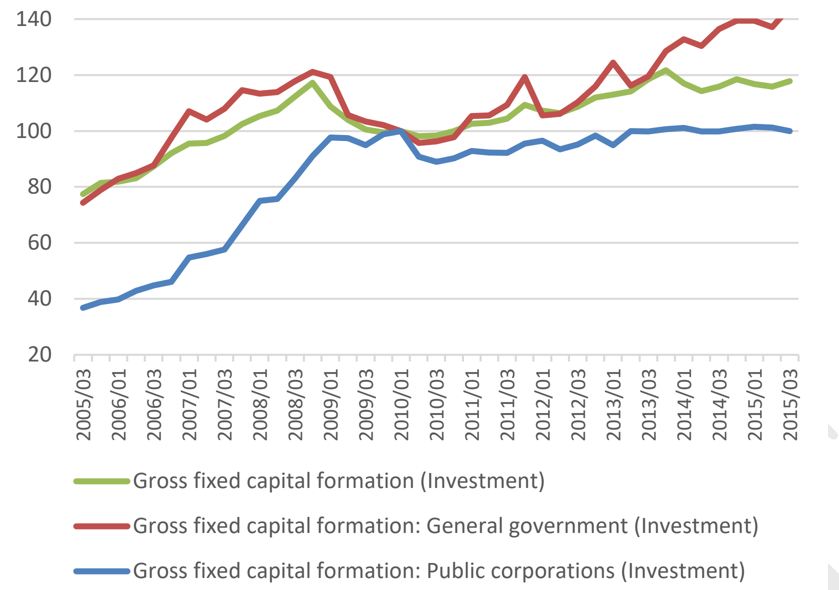
Source: SARB, statistics online

9.2.2.4 *The state as an Investor*

Public investment in the form of general government and of public corporation investment is an important source of investment. In 2014/2015, fixed investment (as GFCF) by the public sector amounted to around 34% of total GCFC; 17% of all GFCF in South Africa was general government GFCF and another 17% of South Africa's GFCF was with public corporations GFCG.

SOEs which have focused on investments in infrastructure, utilities and transport have, at times, through their fixed investments, helped counteract weaker investments by the private sector as well as by government. In fact public sector investment in infrastructure was pushed to help boost the economy (and thus was countercyclical) after 2008/09. General government investment in the form of GFCF has tended, since 2010 to grow faster than the GFCF of public corporations however. Figure 31 in fact shows that investment by public corporations has grown less than all and general government investment for over a decade. General government investment has tended, in contrast, to grow above all investment according to data from the SARB.

Figure 31: Changes in Total, General Government and Public Corporations GFCF (index, Q1/2010=100, using data at 2010 Constant prices)



Source: Own calculations using SARB online data

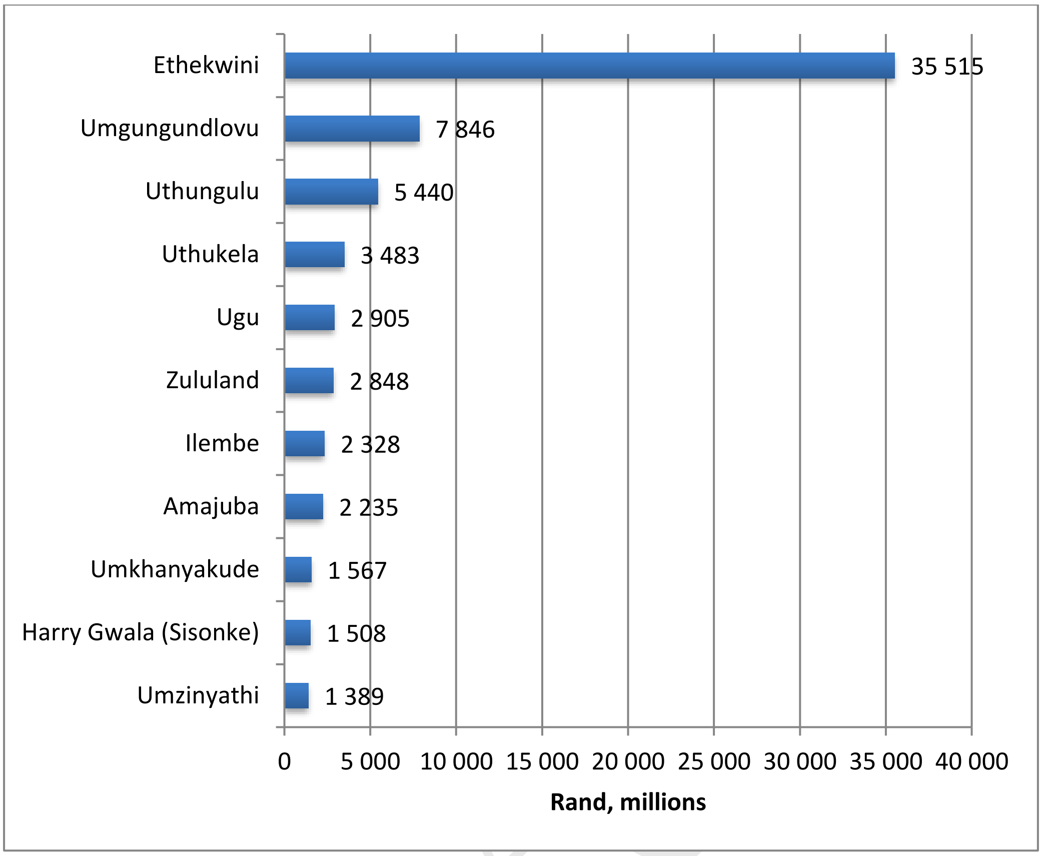
9.3 Domestic Investments in KZN and in Harry Gwala, Umkhanyakude, Zululand

9.3.1 Investment in KZN District and Metro Municipalities

Gross domestic fixed investment (GDFI) in KZN is dominated by eThekwini which accounts for around 53% of the total GDFI of the Province (see Figure 32). In second position, after eThekwini comes Umgungundlovu with, in 2013, around 12% of KZN GDFI. Harry Gwala and Umkhanyakude each accounted for 2.2% of KZN gross domestic fixed investment. Zululand had almost twice that share with 4.2% of KNZ's GDFI.[76]

[76] Although not shown here, these proportions are similar to these Municipalities' share of KZN fixed capital stock.

Figure 32: Gross Domestic Fixed Investment in KZN District and Metro Municipalities, 2013 (R Millions at 2005 Constant Prices)



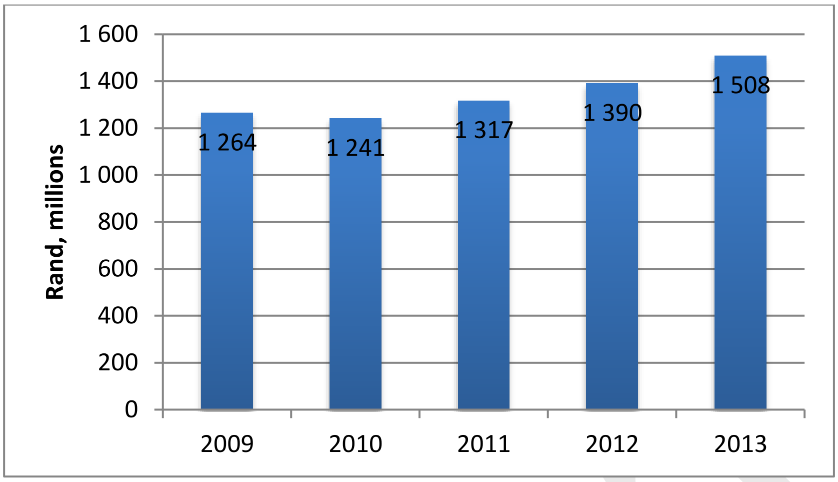
Source: Quantec database.

9.3.1.1 <u>Investments in Harry Gwala, Umkhanyakude, and Zululand DMs</u>

Figure 33, Figure 34 and Figure 35 illustrate that gross fixed investment in the DMs of Harry Gwala, of Umkhanyakude and of Zululand has grown since 2009. Gross fixed investment has markedly increased, in fact, in the Zululand DM since the end of the global economic crisis.

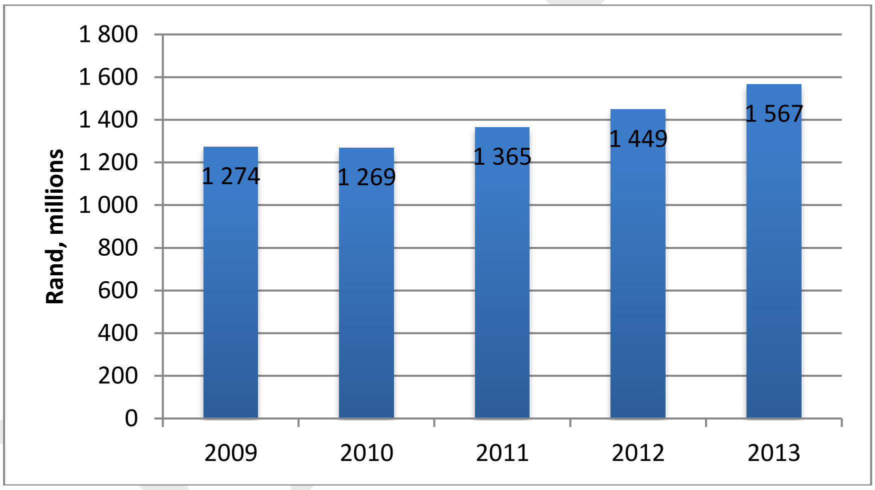
Since 2009, gross fixed investment for the three DMs examined as part of this project has grown more rapidly than in KZN as a whole. There is scope for gross fixed investments in Umkhanyakude and in Harry Gwala to expand further as the share of gross fixed investment in GVA for each of these DMs is below that of KZN (19.6% and 20.7% respectively compared to 22.4% for KZN). Zululand has a share of gross fixed investment in GVA that is slightly above the KZN average (22.6% for Zululand compared to 22.4% for KZN).

Figure 33: Gross Fixed Investment in Harry Gwala District Municipality, 2009-2013 (R Millions, at 2005 Constant Prices)



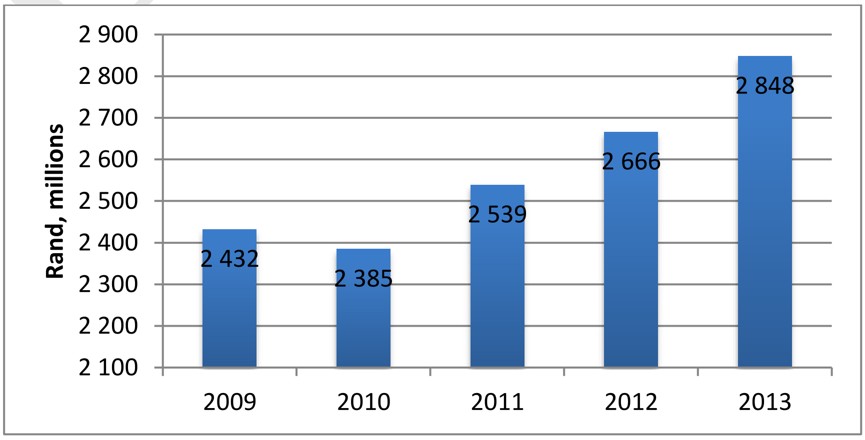
Source: Quantec database

Figure 34: Gross Fixed Investment in Umkhanyakude District Municipality, 2009-2013(R Millions, at 2005 Constant Prices)



Source: Quantec database

Figure 35: Gross Fixed Investment in Zululand District Municipality, 2009-2013 (R Millions, at 2005 Constant Prices)



Source: Quantec database

9.3.2 Investment by sector

Gross fixed domestic investment is taking place largely in the tertiary sector in KZN. Only 5.6% of GDFI was in the primary sector in 2013. The fact that 38.6% of GDFI was then in the secondary sector (where manufacturing is located) reflects the fact that investments are concentrated, in KZN, concentrated in eThekwini as illustrated earlier.

What is observed in Zululand, Umkhanyakude and Harry Gwala is, sectorally, distinct from what is happening in KZN as a whole. These DMs, particularly Zululand, have a comparatively high share of GDFI in the primary sector (see the first part of Table 6). And again, there are nuances across these DMs within the primary sector: about 85% of primary sector GDFI would be with agriculture in Harry Gwala; 59% of Zululand primary sector gross fixed domestic investment would be in mining & quarrying.

The share of GDFI in the tertiary sector in the three DMs scrutinised is relatively similar to that of KZN (see the first part of Table 6). However, GDFI is much more directed to general government in these DMs than in other DMs in the Province.

Table 6: Gross Fixed Domestic Investments in KZN, Zululand, Umkhanyakude and Harry Gwala by sector (% & R millions)

Main economic sector:	KZN	Zululand	Umkhanyakude	Harry Gwala
Primary sector	5.9	17.8	12.9	11.3
Secondary sector	36.8	25.2	28.6	29.3
Tertiary sector	57.3	57.0	58.4	59.4
TOTAL	100	100	100	100

	KZN	Zululand	Umkhanyakude	Harry Gwala
Agri, forestry & fishing	2317	209	127	144
Mining & quarrying	1630	298	76	26
Manufacturing	16248	409	316	244
Electricity, gas and water	7319	259	108	168
Construction	1124	50	24	29
Trade, catering & accommodation	4285	200	166	89
Transport, storage and communication	16681	593	272	353
Finance, insurance, real estate & business services	8357	198	117	187
Community, social and personal services	1535	73	68	46

General government	7568	561	291	222

Source: Quantec Database

9.3.3 Trade in Harry Gwala, Umkhanyakude, and Zululand DMs

We have discussed in Section **Error! Reference source not found.** the key export sectors that have been identified for the three DMs as part of the export strategy. Nonetheless, because exports tend to define where larger and successful firms operate in a geographical space and because exports can signal to a potential investor where there are opportunities and advantages, we touch briefly in what follows on a presentation of the situation of exports for the three DMs analysed in the project. In turn, because imports indicate where demand is unmet from the domestic market (locally or nationally), import data are useful to indicate where there could be supply (import substitution) opportunities.

A first point to note about exports is that the DMs of Harry Gwala, of Umkhanyakude, and of Zululand have tended to perform less well in terms of growing their exports than the Province as a whole, even though a change seems to have occurred in 2013/2014 when exports from Zululand increased abruptly. Generally, the three DMs are very small exporting regions in KZN accounting, jointly, for only 0.21% of the value of KZN exports. Only about 0.18% of KZN exports were from Zululand; exports from Harry Gwala and from Umkhanyakude are negligible according to data from Quantec. This is a second main finding on exports from the DMs.

Focusing on import revealed that the DMs examines contribute very little to total import by the Province as well. The three DMs together accounted, in 2014, for only 0.18% of all KZN imports. Umkhanyakude then accounted for 0.12% of KZN's imports. Imports by that DM have fluctuated markedly since 2004 reflecting ad hoc orders for goods from abroad.

Generally, little trade is a feature of the Harry Gwala, Umkhanyakude, and Zululand DMs.

9.4 Implications of key investment patterns & Trends for a DMIPFS

Domestic and foreign fixed investment are low when South Africa is compared to other emerging economies. Positively, fixed domestic investment as a share of GDP is slowly improving. Moreover, fixed domestic investment in a number of economic sectors, including manufacturing, has grown recently. Negatively, FDI flows to South Africa remain fragile and fluctuate although these have tended to grow since the early 2000s.

There are clear indications, in the analysis of the patterns and trends of fixed investment conducted in this section that such investment needs to notably and firmly expand in South Africa. This expansion will create a number of challenges for DMs but calls for a well framed and targeted DMIPFS in order to be effective.

A challenge for the DMs will, internationally, lie on attracting FDI that is capital intensive but that has strong spillovers onto a labour-intensive growth strategy. Linkages with a mass of domestic firms will be critical for this. This is not an easy objective but a problem with services sectors, which have grown markedly amongst FDI sectors, is that these are less fixed capital intensive (and therefore less fixed investment intensive) than other sectors. Controlling perceptions of risks and uncertainty will be important for this since the slowing down of FDI in manufacturing is related to issues around this. Yet, DMs have to acknowledge that external factors also shape the rise of FDI in services, including the adoption of ICT technologies. This might require attention at the local level.

The analysis has shown that firms from developing and emerging economies have a strong and growing appetite to set themselves up in other developing/emerging countries. These countries drive greenfield, that is new investment. A DMIPFS needs to engage with partners from these regions (directly or through TIKZN), particularly in Asia. Nevertheless, FDI in South Africa remains with some of its traditional trade partners though the USA is now a notable FDI partner. New partners in the Middle East appear to be emerging on the South African scene moreover. DMs will need to understand what potential investors from these various regions require.

An examination of domestic investment data reveals that public investment is a large proportion of fixed domestic investment in South Africa. The data show a sluggish performance of fixed investment by public corporations which implicitly suggests that there is scope for expanded public-private partnership, at least for the provision of particular services.

Focusing on the DMs, we showed that fixed investment in KZN is still concentrated in a few Metros/DMs. The three DMs which we analyse for our project are small contributors to KZN fixed investment. Yet, the DMs are important contributors of fixed investment in the primary sector. Moreover, all three DMs have improved their fixed investment performance post-crisis even though there is still scope to help convert the outcome of economic activities into new fixed investment; the latter is shown through the fact that the share of fixed investment as the proportion of GVA in these DMs is below the KZN average. The hurdles to expanding fixed domestic investment from the current activities in some of KZN's DMs will need to be carefully identified for a DMIPFS to be effective. These elements are those that are detailed in Part 2 of the Situational Analysis report.

10 CONCLUSION

Part 1 of the Situational Analysis report touches upon a great number of themes that are relevant to understand fixed investment and the current state of the domestic and international investment scene. The elements presented were for South Africa and for KZN and both fixed domestic and foreign direct investment were scrutinized for the presentation of the overview. The objective of this particular report was to contextualise the development of the Investment Promotion and Facilitation Strategies for the District Municipalities.

Annexure 1: Summary of Main Trade Agreements between South Africa and the rest of the World

	Type of Agreement	Countries Involved	Main Objective/Terms	Products Involved
Customs Union				
Southern African Customs Union (SACU)	Customs Union	South Africa, Botswana, Lesotho, Namibia and Swaziland	Duty free movement of goods with a common external tariff on goods entering any of the countries from outside the SACU	All products
Free Trade Agreements (FTAs)				
Southern African Development Community (SADC) FTA	Free Trade Agreement	Between 12 SADC Member States	A FTA, with 85% duty-free trade achieved in 2008. The 15% of trade, constituting the "sensitive list", is expected to be liberalised from 2009 to 2012 when SADC attains the status of a fully-fledged FTA with almost all tariff lines traded duty free.	Most products
Trade, Development and Cooperation Agreement (TDCA)	Free Trade Agreement	South Africa and the European Union (EU)	The EU offered to liberalise 95% of its duties on South African originating products by 2010. In turn, by 2012, South Africa offered to liberalise 86% of its duties on EU originating products.	There is currently a review of the agreement underway, which is aimed at broadening the scope of product coverage. This is taking place under the auspices of the Economic Partnership Agreement (EPA) negotiations between SADC and the EU
EFTA-SACU Free Trade Agreement (FTA)	Free Trade Agreement	SACU and the European Free Trade Association (EFTA) - Iceland, Liechtenstein,	Tariff reductions on selected goods	Industrial goods (including fish and other marine products) and processed agricultural

		Norway and Switzerland		products. Basic agricultural products are covered by bilateral agreements with individual EFTA States
Preferential Trade Agreements (PTAs)				
SACU-Southern Common Market (Mercosur) PTA	Preferential Trade Agreement	SACU and Argentina, Brazil, Paraguay and Uruguay	Tariff reductions on selected goods. It is not expected to enter into force before some time in 2012	About 1,000 product lines on each side of the border
Zimbabwe/South Africa bilateral trade agreement	Bilateral Preferential Trade Agreement	South Africa and Zimbabwe	Preferential rates of duty, rebates and quotas on certain goods traded between the two countries	Selected goods. A most recent version of the agreement was signed in August 1996, which lowers tariffs and quotas on textile imports into South Africa.
Non-reciprocal Trade Arrangements				
Generalised System of Preferences (GSP)	Unilateral preferences granted under the enabling clause of the WTO that are not contractually binding upon the benefactors	Offered to South Africa as developing country by the EU, Norway, Switzerland, Russia, Turkey, the US, Canada and Japan	Products from developing countries qualify for preferential market access	Specified industrial and agricultural products
Africa Growth and Opportunity Act (AGOA)	Unilateral assistance measure	Granted by the US to 39 Sub-Saharan African (SSA) countries	Preferential access to the US market through lower tariffs or no tariffs on some products	Duty free access to the US market under the combined AGOA/GSP programme stands at approximately 7,000 product tariff lines.

Other Agreements				
Trade, Investment and Development Cooperation Agreement (TIDCA)	Cooperative framework agreement	SACU and US	Makes provision for the parties to negotiate and sign agreements relating to sanitary and phyto-sanitary measures (SPS), customs cooperation and technical barriers to trade (TBT). It also establishes a forum of engagement of any matters of mutual interest, including capacity-building and trade and investment promotion.	None
Trade and Investment Framework Agreement (TIFA)	Bilateral agreement	South Africa and US	Provides a bilateral forum for the two countries to address issues of interest, including AGOA, TIDCA, trade and investment promotion, non-tariff barriers, SPS, infrastructure and others.	None
Current Trade Negotiations				
SACU-India PTA	Preferential Trade Agreement	SACU and India	Tariff reductions on selected goods	SACU and India are in the process of exchanging tariff requests
SADC-EAC-COMESA Tripartite FTA	Free Trade Agreement	26 countries with a combined GDP of US$860 billion and a combined population of approximately 590 million people	The Tripartite Framework derives its basis from the Lagos Plan of Action and the Abuja Treaty establishing the African Economic Community (AEC), which requires rationalisation of the continent's regional economic communities. The FTA will be negotiated over the next three years, with the possibility of an additional two years for completion.	The Tripartite initiative comprises three pillars that will be pursued concurrently, in order to ensure an equitable spread of the benefits of regional integration: market integration, infrastructure development and industrial development. The FTA will, as a first

				phase, cover only trade in goods; services and other trade-related areas will be covered in a second phase.