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New Horizons and Policy Challenges for Foreign Direct Investment in the 21st Century

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FOREIGN DIRECT INVESTMENT IN SOUTH AFRICA

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INTRODUCTION

South Africa's economy is the largest in sub-Saharan Africa: more than four times larger than that of the rest of Southern Africa.

Since South Africa's transition to democracy in 1994, the economy has undergone a major transformation. This has included:

- Signing up to the WTO and the consequent extensive phase down of import tariffs.
- Commitment to a sound macro-economic policy in the form of the Growth, Employment and Redistribution (GEAR) framework, which has resulted in the stabilisation of key macroeconomic variables, such as inflation, the budget deficit to GDP ratio and real interest rates.
- The completion of Free Trade Agreements (FTA's) with the European Union and the Southern African Development Community (SADC), qualification for preferential tariff access in terms of the unilateral US Africa Growth and Opportunity Act (AGOA) as well as ongoing negotiations with respect to an FTA with MERCOSUR.

These policy measures have led to steady economic growth, strong export growth and the attraction of Foreign Direct Investment from a wide range of countries.

FDI STOCK, ANNUAL FLOWS AND SECTORAL BREAKDOWN

Tabulated below are South Africa's inflows of FDI over the last few years, as well as the latest available stock position, broken down by sector.

Annual FDI inflows, 1993 – Q2 2001 (Rand millions)

1993	1994	1995	1996	1997	1998	1999	2000	Q1 2001	Q2 2001
33	1348	4502	3515	17587	3104	9184	6083	1726	52872

* This report has been compiled by South Africa's official export and foreign direct investment promotion agency: Trade and Investment South Africa.

Source: South African Reserve Bank Quarterly Bulletin

According to official statistics FDI into SA has been on a general upward trend since 1994. Big inflows were recorded in 1997 and 1999, which were largely related to the partial privatisation of state assets, namely Telkom (telephone operator) and South African Airlines. 2000 recorded inflows of R6bn.

R1,7bn in FDI flowed in during the first quarter of 2001. The second quarter of 2001 recorded a massive inflow of R52 billion. This figure is unusually high and the largest share of that it is attributed to the buy-out of the De Beers minority shareholders by (London Stock Exchange listed) Anglo American.

Notwithstanding this, evidence from the official foreign direct investment and export promotion agency Trade and Investment South Africa (TISA) activities indicate the likelihood of a strong inflow of 'normal' FDI for 2001.

TISA Committed investments: 1 April to 25 October 2001

Sector	Source	Value (Rm)	Type	Region in SA
Automotive	Italy	71	Brownfield	Port Elizabeth
Automotive	Germany	1,500	Expansion	Pretoria
Automotive	USA	70	Greenfield	Port Elizabeth
Automotive	Germany	12	Expansion	Port Elizabeth.
Automotive	USA	12	JV	Cape Town
Metals	Italy	100	JV	Johannesburg
Chemicals	Switzerland	15	To be confirmed	
Chemicals	Netherlands	270	New	Sasolburg, Free State
Chemicals	Algeria	40	New	Bethlehem, Free State
Chemicals	UK	50	New	Cape Town
Chemicals	SA/Japan	1,120	New	Sasolburg, Free State
Chemicals	Zimbabwe	8	New	Johannesburg
Chemicals	UK	50	New	Sasolburg, Free State
Chemicals	South Korea	18	New	Port Elizabeth
Clothing & Textiles	USA	50	Expansion (JV)	Western Cape
Clothing & Textiles	UK	150	Expansion (JV)	Western Cape
Clothing & Textiles	UK	169	New	Atlantis, Western Cape
Agro-processing	UK	25	New	Gauteng
Agro-processing	Germany	180	New	KwaZulu Natal
Agro-processing	Germany	165	New	Eastern Cape
		4,075		

Although these investments are committed, rather than realised, and are consequently subject to change, they are indicative of the scale and nature of FDI South Africa has been attracting in 2001.

A further dimension of these investments is that, in contrast to the nature of FDI in many emerging markets over the last few years (including South Africa), none of the investments indicated below are privatisation related. This implies that they generally add to the capital stock.

Investments have largely fallen into three major sectors: automotives, chemicals and clothing and textiles. This is attributable to major recent investment interest in the automotive sector, chemicals projects ranging from pharmaceuticals and cosmetics to industrial chemicals, as well as investments in apparel and agro-processing related to AGOA and the EU free trade agreement.

In regional terms, a range of companies in east Asia and Europe have shown a keen interest in the South Africa, driven by competitive input prices and opportunities that have been created by trade agreements. The revitalisation of the automotive sector has attracted major European investors. Clothing and Textiles investments from European companies have been made largely to take advantage of preferential access to the US market via AGOA.

Returning to official FDI statistics, the table below demonstrates the official FDI stock position, broken down by sector, as at the end of December 1999. These are the latest official stock figures available.

Sectoral breakdown of FDI stock, 31 December 1999 (Rand millions)

Agriculture	Min ing	Manufac turing	Electri city	Construc tion	Wholes ale	Transp ort	Finan cial	Commu nity services	Tota l
406	1140 95	79486	-	506	10596	8411	10499 2	138	3186 30

Source: South African Reserve Bank Quarterly Bulletin

The stock figures above, are of limited use. This is because they aggregate all historical FDI in particular sectors and are not a good guide to recent developments. For instance, South Africa has long been an economy with a strong mining base, and hence the largest stock of FDI falls within mining, which has been accumulated for more than a century. However, over the last few years, only a small proportion of South Africa's FDI has occurred within the mining sector.

Official flow statistics provided by the Reserve Bank, do not provide a breakdown of FDI flows by sector, source country, region or type of investment. This is an important issue, and TISA is currently engaged with the Reserve Bank in order to facilitate the collection of more detailed official FDI flow and stock figures.

GOVERNMENT POLICIES AFFECTING THE FDI ENVIRONMENT

In principle, and in accordance with its WTO obligations, South Africa does not discriminate between domestic and foreign investors. Therefore the major policy framework which impacts on FDI is the macroeconomic framework: GEAR

Macroeconomic Policy

The core elements of GEAR are:

- fiscal deficit reduction to contain debt service obligations, counter inflation and free resources for investment;
- an exchange rate policy to keep the real effective rate stable at a competitive level;
- consistent monetary policy to prevent a resurgence of inflation.
- restructuring of state assets to optimise investment resources;

- an expansionary infrastructure programme to address service deficiencies and backlogs;
- a commitment to the implementation of stable and coordinated policies.

The GEAR strategy has been successful in stabilising major macro variables. This includes the inflation rate, the budget deficit relative to GDP, as well as the balance of payments. Growth has been lower than projected, but the economy has continued to grow despite difficult conditions after the 1998 financial crisis and the recent global slowdown. Growth is predicted to outstrip most other emerging economies in 2002 and hence to weather the post September 11 storm.

Key macro-economic variables, 1997 – Q2 2001

	1997	1998	1999	2000	Q1 2001	Q2 2001
Real GDP (Rand billion)	533	537	548	566	575	579
GDP per capita (R '000)	16.6	17.5	18.5	19.9	N/A	N/A
Real GDP growth (%)	2.5	0.7	1.9	3.1	2.0	2.3
Balance of Payments (Rand bn)	10.8	-4.0	25.8	5.1	-0.6	8.0
Budget deficit as % of GDP	4.5	2.9	2.0	2.0	N/A	N/A
Inflation rate (%)	8.5	6.9	5.2	5.3	7.5	6.3
Net Open Forward Position (US \$ billion)	-16.2	-22.5	-13.0	-9.5	-9.4	-5.3
Foreign debt to GDP	26.4	28.2	29.9	29.3	N/A	N/A

Source: South African Reserve Bank Quarterly Bulletin

Industrial Strategy

South Africa's Industrial Strategy, as articulated by the Department of Trade and Industry, is focussed on increasing value addition within the South African economy, lowering costs, and shifting the economy into more knowledge intensive activities.

South Africa is endowed with raw materials, cheap energy, and a solid infrastructure, which provides a competitive advantage in a range of processing activities. However, there have been significant shifts towards more high-value added activities, supported by supply-side measures. A good example of this is the impact the Motor Industry Development Programme (MIDP) has had on attracting major international players and upgrading the automotive industry.

More recently, the focus of industrial strategy has shifted toward the creation of a knowledge economy. This strategy seeks to address competitiveness directly through encouraging under-provided activities such as skills, research and development and the deeper penetration of information technologies into the economy.

South Africa's industrial strategy generates opportunities for FDI in a range of activities. These include mineral processing, energy-intensive investments, as well as increasingly in high-tech and services sectors.

The Industrial Strategy is actively supported by selected investment incentives. These include:

- **The Strategic Investment Programme (SIP)** – a tax allowance for large investments with strong employment and linkage effects.
- **The Small and Medium Enterprise Development Programme (SMEDP)** – a cash grant for small and medium manufacturing, tourism, high-value agriculture and aquaculture enterprises.
- **Skills Support Programme (SSP)** – a cash grant to support training of employees.
- **Critical Infrastructure Fund (CIF)** – a fund which can underwrite part of the cost of infrastructure undertaken by a local authority, which is necessary to ensure a particular investment.
- **Foreign Investment Grant (FIG)** – assistance with relocation costs.

Trade Strategy

South Africa's trade strategy has concentrated on gaining preferential access to important markets alongside a tariff phase down. Access to the European Union (EU) and the Southern African Development Community (SADC) markets have been facilitated via the conclusion of Free Trade Agreements (FTA's). The next phase of this strategy encompasses building strong trade relations with major emerging markets, such as Brazil, India and Nigeria. The access afforded to the United States market by the African Growth and Opportunity Act (AGOA) has served to bolster this strategy. South Africa is already beginning to reap the benefits of AGOA with large increases in exports to the United States in the first few months of meeting the qualification criteria (in March 2001).

The trade access negotiated or afforded to South Africa creates significant opportunities for FDI, in order to take advantage of preferential access to major markets.

Microeconomic reforms

While the macro level reforms identified above have resulted in a sound macroeconomy and, the focus of policy has shifted towards addressing issues which cannot be adequately dealt with at the macro level. These included the following:

- Restructuring and privatisation of state assets to ensure greater economic efficiencies. This applies particularly to the transport parastatals.
- Addressing unemployment more directly through some form of wage or employment support, as well as revisiting South Africa's labour legislation.
- Improving skills levels to increase employment, as well as address the skills needs of industry through reform of the immigration framework.

These reforms are aimed at lowering the costs of doing business, lowering unemployment and increasing industry access to the skills it needs.

LEGAL FRAMEWORK AND FINANCIAL INFRASTRUCTURE

South Africa has a constitution which protects property rights, and an independent judiciary. It has a sophisticated commercial law. Its financial infrastructure is world-class with the presence of most major international banks.

The breadth of financial products and services is unparalleled in other emerging market economies, and there is depth as well: the stock market is the 13th largest in the world, and the bond market offers first-world size and liquidity. (World Bank 2001: Discussion Paper 16).

Consequently foreign investors, by and large, face the same legal and regulatory environment as domestic investors. There are certain regulations, however, which are unique to foreign investors, and tend to be for reporting or balance of payments reasons. These include:

- Foreign companies are required to register as external companies before immovable property may be registered in their names.
- There is a restriction on the local borrowings of business entities, which are 75% or more owned or controlled by non-residents.

Exchange controls have effectively been abolished in relation to non-residents, and the Government is pursuing a policy of gradually relaxing the remaining exchange controls applicable to residents.

PROBLEM AREAS HIGHLIGHTED BY INVESTORS

South Africa is like any other developing country in the sense that foreign investors do experience difficulties during the investment process. The following are the major areas of concern that have been reported by foreign investors.

- A general burden of bureaucracy at different levels of government with respect to setting up business. This includes issues such as:
 - Lack of information with respect to the requirements to set up a plant
 - Long lead times for utilities such as electricity and telephones
 - Inadequate bandwidth
- Difficulties in securing work permits for managers and professionals, as well as long waiting periods for such documentation.
- Costs and ‘hassle factor’ of compliance with labour legislation.
- Inadequate investment incentives.

Trade and Investment South Africa works actively to resolve these problems. This occurs through direct intervention with the relevant government department, local authority or parastatal. It also includes ongoing interventions at the policy level, in order to improve the business environment in South Africa.

POLICY MESSAGES

From the perspective of TISA there is some measure of frustration with respect to the manner in which South Africa is classified as an investment destination. Despite the much praised establishment of sound macroeconomic fundamentals and ongoing improvements in South Africa’s rating for portfolio investment by agencies such as Standard and Poor and Moody’s, TISA feels that South Africa has not attracted as much FDI as its economic fundamentals justify.

While there are undeniable socio-economic problems such as high unemployment and HIV/AIDS levels, it is felt that these factors do not adequately account for the levels of investment seen so far. Financial crises in certain economies have had a spill-over effect on others as portfolio investors withdraw from the basket of ‘emerging markets’, despite the lack of any linkage between certain emerging economies. This has a negative impact on direct foreign investment.

The policy message that TISA wishes to see from the OECD conference is that there should be a more informed evaluation of emerging market economies in general and promising African economies in particular. Undue Afro-pessimism should not lead to irrational investment decisions.

SOUTH AFRICAN INCOME TAX SYSTEM

The South African Tax system, in line with the international community has changed from a source based to a residence-based system with effect from the 1 January 2001. This means that South African residents will be taxed on their worldwide income. Non- SA residents will still be taxed on income from SA source subject to the Double taxation agreements with the different Countries.

PRINCIPAL TAXES

SA imposes the following direct and indirect taxes:

Direct Taxes

Income Tax, Secondary Tax on Companies (STC), Capital Gains Tax and Donations Tax

Indirect Taxes

Value Added Tax, Estate Duty, Stamp Duties, Transfer duties, Excise and Customs Duties, Marketable Security Taxes, Regional Services Council Levies, Skills Development levies

Income Tax

Income tax is imposed on individuals, small business corporations, and employment companies, Companies and other business corporations.

Companies pay income tax at the rate of 30% and in addition, Companies pay Secondary Tax on Companies (STC) on dividends declared at the rate of 12.5%. Small business corporations are taxed at the rate of 15% for the first R100 000 of taxable income and 30% for amounts in excess of R100 000. Employment Companies or labour brokers are taxed at a 35% rate. In the case of natural persons tax is levied at progressive rates from 18% to 42%.

Other entities like Partnerships are not regarded as separate legal entities and therefore income earned by the partnerships will be taxed in the hands of the individual partners separately in the proportion of their interests. Trusts are generally regarded as conduit of income to the beneficiaries, therefore income earned by trusts is normally taxed in the hands of the beneficiaries. Trusts, which do not distribute income to the beneficiaries, are taxed separately at the rate of 32% for amounts up to R100 000 and at the rate of 42% for income in excess of R100 000. Employers are required to deduct employee's tax from remuneration earned by their employees and directors

Donations tax

Donation tax is payable on property disposed off by means of a donation by SA residents and companies incorporated or managed and controlled in SA (excluding public companies) at the rate of 25%, reduced to 20% from 1st October 2001. Donations by individuals up to R25 000 per annum are exempt from tax.

Capital Gains Tax (CGT)

SA has introduced CGT with effect from 1st October 2001. CGT will apply to SA residents on worldwide assets, or Non-SA residents on immovable property in SA or assets of a branch or agency in SA. A disposal of an asset will trigger CGT. A portion of the gain realised on the sale of an asset will be included on the taxable income of a taxpayer at the rate of 50% if it is a company, close corporation, business or family trust. Gains realised by natural persons will be included at the rate of 25%. A primary residents occupied by the owner is exempt from CGT. Assets owned by exempt institutions, private motor vehicles and personal belongings and lump-sum benefits of most super annuation and life assurance policies are also exempt from CGT.

Branches of Foreign Companies

An external company or the South African of a foreign company, which has its place of effective management outside South Africa will be subject to a tax of 35% on taxable income derived from a source within SA, in respect of years of assessment ending on or after 1 April 1996.

Estate Duty

Estate duty is levied in respect of the property of every person at the date of his/her death at the rate of 20%. The first R1million of the estate is exempt.

Excise and Customs duties

Excise duties is a tax imposed on certain commodities produced locally e.g. automobiles, jewellery, beer and wine. Imported goods are subject to similar levies in the form of customs duties. A rebate of customs duty can be obtained if the imported goods are to be used in manufacturing for export.

Regional Services Council levies

The Metropolitan councils impose regional services levy on businesses and joint services Boards for the supply of basic services within their regions. It is based on the gross consideration received by the business and on salaries paid to employees.

Marketable Securities

Is imposed on the purchase of listed marketable securities e.g. Shares listed on the stock exchange. The tax is 0.25% of the consideration paid in the transaction.

Stamp Duties

Is imposed on contractual documentary agreements. Some stamps are at a fixed amount and others at ad valorem rates.

Transfer Duties

This is a duty on transfers of immovable property based on the value of the property that is transferred.

Value Added Tax (VAT)

VAT is levied at the rate of 0% and 14% on most transactions involving the supply and consumption of goods and services including immovable property.

FOR FURTHER INFORMATION

Useful tax brochures are available on
http://www.sars.gov.za/it/brochures/income_tax_brochures_main.htm

An extensive "Exchange Control Manual" is available on
<http://www.resbank.co.za>

The following may also be of relevance, eg to monitor perceptions:

1. Submission by the South African Chamber of Business (SACOB) to the Portfolio Committee on Finance concerning the Draft Taxation Laws Amendment Bill 2001: Proposed Introduction of Capital Gains Tax:
http://www.cgtsa.co.za/discuss/010801_01.htm.
2. Focus on the new Africa: UNCTAD Fact sheet on Foreign Direct Investment:
http://www.unctad.org/en/pub/fdiafrica_fact.htm
3. South Africa as an International Economic Player:
<http://www.southafricahouse.com/documents/CBI.htm>
4. Africa Matters:
<http://www.voa.gov/thisweek/library/archive/aug01/africa%20matters.html>